

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 41 and 140

RIN 3038-AB81

Exemption for Certain Brokers or Dealers from Provisions of the Commodity Exchange Act and CFTC Regulations

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rules.

SUMMARY: In accordance with certain provisions of the Commodity Futures Modernization Act of 2000 (“CFMA”), the Commodity Futures Trading Commission (“Commission” or “CFTC”) has adopted, substantially as proposed, new Rule 41.41. This rule establishes procedures for granting requests for orders exempting certain brokers or dealers (“BDs”) registered with the Securities and Exchange Commission (“SEC”) from provisions of the Commodity Exchange Act (the “Act”) and/or the Commission’s regulations where the Commission determines that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors. The Commission is also permitting securities industry self-regulatory organizations (“SROs”) to submit such requests for exemptive orders on behalf of their members, and it is delegating to the Director of the Division of Trading and Markets authority to grant, to conditionally grant, or to deny, any such requests for exemptive orders.

EFFECTIVE DATE: [INSERT DATE 30 DAYS AFTER DATE OF PUBLICATION IN THE *FEDERAL REGISTER*].

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SUPPLEMENTARY INFORMATION:

I. Background

The CFMA, signed into law on December 21, 2000, effected, among other things, removal of the restriction in the Act¹ on the trading of futures contracts on individual equity securities and narrow-based indices of equity securities.² Under the revised law, security futures products³ may be traded on a designated contract market or on a registered derivatives transaction execution facility (“DTF”).⁴

Section 4d of the Act provides that any person who engages in soliciting or accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any designated contract market or DTF – *e.g.*, for a security futures product – must be registered

¹ 7 U.S.C. 1 *et seq.*, as amended by Pub. L. No. 106-554, 114 Stat. 2763 (2000). The text of the CFMA may be accessed on the Internet at <http://agriculture.house.gov/txt5660.pdf>.

² See Section 251(a) of the CFMA. This trading previously had been prohibited by Section 2(a)(1)(B)(v) of the Act.

³ The term “security futures product” is defined in Section 1a(32) of the Act to mean “a security future or any put, call, straddle, option, or privilege on any security future.” The term “security future” is defined in Section 1a(31) of the Act. Because the CFMA also provides that options on security futures cannot be traded until December 21, 2003 at the earliest, security futures are the only security futures product that may be available for trading during the next 27 months.

⁴ The CFMA also specifically prescribes certain dates on which security futures trading can commence. For example, retail transactions cannot commence until December 21, 2001. Section 202(a) of the CFMA; Section 6(g)(5) of the Securities Exchange Act of 1934 (“the ‘34 Act”).

with the Commission as: (1) a futures commission merchant (“FCM”), if it also accepts any money, securities, or property, or extends credit in lieu thereof, to margin, guarantee, or secure futures contracts; or (2) an introducing broker (“IB”), if it does not accept money or other property to margin, guarantee or secure futures contracts.⁵ Section 4f(a)(1) of the Act provides that application for registration as an FCM or IB “shall be made in such form and manner as prescribed by the Commission.”⁶ Pursuant to this authority, the Commission adopted Rule 3.10, which currently requires that an applicant for registration as an FCM or IB file prescribed registration and financial report forms.⁷

However, as a result of the CFMA, new Section 4f(a)(2) of the Act⁸ now provides that, notwithstanding Section 4f(a)(1), any BD⁹ that is registered with the SEC shall be registered as an FCM or IB, as applicable, “effective contemporaneously with the submission of notice,” if:

(A) the broker or dealer limits its solicitation of orders, acceptance of orders, or execution of orders, or placing of orders on behalf of others involving any contracts of sale of any commodity for future delivery, on or subject to the rules of any contract market or registered derivatives transaction execution facility to security futures products;

⁵ See Sections 1a(20) and (23) of the Act, which define the terms “futures commission merchant” and “introducing broker,” respectively.

⁶ Prior to the enactment of the CFMA, this provision was found in Section 4f(a) of the Act. The CFMA (at Section 252(b)) amended Section 4(f) by redesignating paragraph (a) as paragraph (a)(1) and by adding new paragraphs (a)(2) and (a)(3) (Section 252(b)(2) of the CFMA) and (a)(4) (Section 252(c) of the CFMA).

⁷ Commission regulations referred to herein are found at 17 CFR Ch. I (2001).

⁸ As set forth in Section 252(b) of the CFMA.

⁹ Because the CFMA speaks in terms of a “broker or dealer,” the term “BD” as used in this release applies equally to a broker, a dealer or a person registered as both a broker and a dealer.

(B) the broker or dealer files written notice with the Commission in such form as the Commission, by rule, may prescribe containing such information as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors;

(C) the registration of the broker or dealer is not suspended pursuant to an order of the Securities and Exchange Commission; and

(D) the broker or dealer is a member of a national securities association registered pursuant to section 15A(a) of the '34 Act.

Accordingly, in a separate *Federal Register* release, the Commission proposed to amend Rule 3.10 to provide for FCM and IB notice registration thereunder.¹⁰

New Section 4f(a)(3) of the Act¹¹ provides a similar exemption (without the notice filing requirement) from the requirement under Section 4e of the Act to register as a floor broker (“FB”) or floor trader (“FT”). An FB or FT is exempt from registration as such if:

(A) the floor broker or floor trader is a broker or dealer registered with the Securities and Exchange Commission;

(B) the floor broker or floor trader limits its solicitation of orders, acceptance of orders, or execution of orders, or placing of orders on behalf of others involving any contracts of sale of any commodity for future delivery, on or subject to the rules of any contract market to security futures products,¹² and

¹⁰ See *Notice Registration as a Futures Commission Merchant or Introducing Broker for Certain Securities Brokers or Dealers*, 66 FR 27476 (May 17, 2001). Section 4k(1) of the Act generally requires each person who is an associated person (“AP”) of an FCM or IB to register as such. The CFMA exempts from registration the APs of FCMs and IBs who would be subject to notice registration.

¹¹ As set forth in Section 252(b) of the CFMA.

¹² Of course, an FT is restricted to executing orders for his or her own account and the Commission does not view this provision of the CFMA as expanding the scope of activities in which an FT may engage.

(C) the registration of the floor broker or floor trader is not suspended pursuant to an order of the Securities and Exchange Commission.

Persons registered as FCMs or IBs pursuant to the notice registration procedure of new Section 4f(a)(2) and persons who are exempt from FB or FT registration pursuant to new Section 4f(a)(3) are expressly exempted by new Section 4f(a)(4)¹³ from certain enumerated provisions of the Act, as well as the Commission's rules that were promulgated under those provisions.¹⁴ Moreover, such persons are not required to become members of NFA and the prohibition in NFA's By-Laws against NFA members transacting business with non-members does not apply.¹⁵

¹³ As set forth in Section 252(c) of the CFMA.

¹⁴ Those provisions include: Section 4c(b) – regulation of commodity options trading by the Commission; Section 4c(d) – dealer options exemption; Section 4c(e) – Commission authority to ban dealer options; Section 4c(g) – requirement for contemporaneous written record of all orders for execution on the floor or subject to the rules of a designated contract market or DTF; Section 4d – registration requirements for FCMs and IBs and customer funds segregation requirement for FCMs; Section 4e – registration requirement for FBs and FTs; Section 4h – prohibition of misrepresentation that a person is a member of a registered entity, that a person is registered with the Commission, or that a futures contract will be or has been executed on a registered entity; Section 4f(b) – FCM and IB minimum financial requirements; Section 4f(c) – FCM risk assessment requirement; Section 4j – restrictions on dual trading in security futures products; Section 4k(1) – registration requirement for APs of FCMs and IBs; Section 4p – proficiency testing and ethics training requirements for registrants; Section 6d – State causes of action under the Act and Commission right to intervene or appeal; Section 8(d) – Commission's obligation to investigate commodity marketing conditions and to furnish reports to producers, consumers and distributors; Section 8(g) – Commission obligation to disclose information concerning registrants to State governments and political subdivisions thereof; and Section 16 – Commission authority to investigate markets and to furnish reports to the public on a regular basis. APs of BDs who limit their futures-related activities to security futures products are also exempt from registration under the Act and the same provisions of the Act and rules thereunder cited in this footnote. *See* Section 252(d) of the CFMA.

¹⁵ The final subparagraph of new Section 4f(a)(4) provides that: (1) a person that is notice-registered as an FCM or IB pursuant to new Section 4f(a)(2) or an AP thereof, or that is an FB or FT exempt from registration under new Section 4f(a)(3), need not become a member of a
cont. . . .

In addition to the statutory exemption from enumerated sections of the Act (and the rules adopted under those sections) granted to BDs that notice-register as FCMs or IBs under new Section 4f(a)(2), or that are exempt from FB or FT registration under new Section 4f(a)(3), the CFMA authorizes the Commission to further exempt such BDs, by rule, regulation or order from any provision of the Act or the Commission's rules, to the extent the exemption is necessary or appropriate in the public interest and is consistent with the protection of investors. The CFMA also directs the Commission to determine, by rule or regulation, the procedures under which an order under new Section 4f(a)(4)(B) shall be granted.¹⁶

In response to the CFMA's directions to establish rules for requesting and granting exemptive orders, the Commission proposed the rule changes the adoption of which is announced by this *Federal Register* release.¹⁷ In the Proposing Release, the Commission also sought comments regarding specific sections of the Act or provisions of the Commission's rules, beyond those already specified in the CFMA, from which such BDs should be made exempt by rule.

II. Application for an Order Granting Additional Exemptive Relief.

New Section 4f(a)(4)(B)(i) of the Act provides that the Commission may issue an order to exempt, conditionally or unconditionally, any BD subject to notice registration under new

registered futures association; and (2) a registered futures association may not prevent its members from transacting business with a person that is exempt under new Sections 4f(a)(2) or (a)(3).

¹⁶ New Section 4f(a)(4)(B)(ii) of the Act, as set forth in Section 252(c) of the CFMA. The statute gives the Commission discretion to decline to entertain an application for such an order.

Section 4f(a)(2) of the Act, or any BD exempt from floor broker or floor trader registration pursuant to new Section 4f(a)(3), from any provision of the Act or any provision of the Commission's regulations to the extent that the exemption is necessary or appropriate in the public interest and is consistent with the protection of investors. New Section 4f(a)(4)(B)(ii) directs the Commission to determine the procedures by which an exemptive order under Section 4f(a)(4)(B) shall be granted, and vests the Commission with sole discretion to decline to entertain any application for such an order.¹⁸ Accordingly, the Commission proposed, and sought comments regarding, procedures for applying for an exemptive order under Section 4f(a)(4)(B) of the Act.¹⁹

As proposed, Rule 41.41 called for applicants to supply either a written application or an electronic mail submission containing the applicant's name, main business address and phone number, information about the applicant's registration status with the SEC (and assurance that the registration is not subject to a suspension), the specific section(s) of the Act or provision(s) of Commission rules from which exemption is sought, any applicable analogous provisions of the securities laws and regulations, an explanation of the facts and circumstances under which the applicant believes that the requested exemptive relief is necessary or appropriate in the public interest, and an explanation of the extent to which the requested exemptive relief is

¹⁷ See *Exemption for Certain Brokers or Dealers from Provisions of the Commodity Exchange Act and CFTC Regulations*, 66 FR 20118 (April 19, 2001) (the "Proposing Release").

¹⁸ The CFMA places no corresponding obligation upon the SEC.

¹⁹ As noted in the Proposing Release, exemption from the sections of the Act listed in Section 4f(a)(4)(A) is automatic, and it is therefore unnecessary for persons to request exemptive orders with respect to those sections or the rules that were adopted thereunder.

consistent with the protection of investors. The last two items contain the standards upon which the CFMA requires the Commission to base the grant of a request for an order. The proposed rule also stated that the grant or denial of a request is within the Commission's sole discretion (as specifically provided in the CFMA).

The Commission received one comment letter in response to the Proposing Release. The commenter urged that a national securities exchange should have the right to request an exemptive order under Section 4f(a)(4)(B) on behalf of the exchange's members. The commenter, itself a national securities exchange, believes it is particularly qualified to inform the Commission of the potential impact of self-regulatory organization ("SRO") rules, Federal securities laws and Commission regulations on the exchange's members. The commenter also asserted that regulatory efficiency would be enhanced by the submission of one request for an exemptive order instead of multiple requests, and the issuance of one order, instead of multiple orders with the potential for dissimilar treatment of similarly situated requesters. The Commission agrees with the commenter's rationale and notes that, under Rule 30.10, the rule permitting petitions for exemption from any of the Commission's rules governing foreign futures and options transactions, the Commission considers petitions from a foreign regulatory agency or SRO on behalf of the agency's regulatees or the SRO's members, respectively. Accordingly, as adopted, paragraph (c) of Rule 41.41 reads "A national securities exchange or other securities industry self-regulatory organization may submit an application for an order pursuant to this section on behalf of its members." The text of Rule 41.41 is otherwise adopted as proposed.

We note for the sake of clarity that an application for an exemptive order under Rule 41.41 that meets the procedural requirements of the new rule need not also comply with the requirements of Rule 140.99 ("Requests for exemptive, no-action and interpretative letters").

III. Delegation of Authority.

In the Proposing Release, the Commission proposed to delegate to the Director of the Division of Trading and Markets authority to grant or deny applications for exemptive orders under proposed Rule 41.41. With respect to the granting and denying of applications for exemptive orders, the Commission intended this delegation to expedite the procedure and to place consideration of exemptive orders with the staff members most directly involved in exemptive matters. The Commission stated its belief that this delegation will maximize regulatory efficiency with respect to these proposed rule changes.

No comments were received regarding the proposed delegation of authority.

Accordingly, new paragraph (a)(8) of Rule 140.93 is adopted as proposed.

IV. Other Comments

In addition to suggesting that a national securities exchange be permitted to request exemptive orders under new Section 4f(a)(4)(B) on behalf of the exchange's members, the sole comment letter received in response to the Proposing Release also contained two other comments. The first of these comments asserted that the Commission should exempt by rule or regulation persons that perform the functions of FBs and FTs on the floor of a national securities exchange with respect to security futures from the provisions of the Act and Commission rules thereunder that are covered by comparable provisions of the '34 Act, SEC Regulations and applicable exchange rules. The commenter proposed that the following Commission rules could be thus dispensed with: Rule 1.38 (Execution of transactions); Rule 1.39 (Simultaneous buying and selling orders of different principals; execution of, for and between principals); Rule 1.62 (Contract market requirement for floor broker and floor trader registration); Rule 1.63 (Service on self-regulatory organization governing boards or committees by persons with disciplinary

histories); Rule 1.64 (Composition of various self-regulatory organization governing boards and major disciplinary committees); Rule 1.69 (Voting by interested members of self-regulatory organization governing boards and various committees); Part 18 rules (Reports by traders); Rule 155.2 (Trading standards for floor brokers); Rule 155.5 (Prohibition on dual trading by floor brokers); and Rule 156 (Broker associations).

We note that the CFMA exempts from Section 4j of the Act (which governs restrictions on dual trading) contract markets notice-designated as such under Section 5f of the Act, which would include national securities exchanges, national securities associations or alternative trading systems.²⁰ Thus, although designated contract markets and DTFs will be subject to Section 4j of the Act and dual trading rules thereunder,²¹ the commenter's suggestion with respect to Rules 155.2 and 155.5 is now moot.²²

With respect to Rules 1.63, 1.64 and 1.69, these rules concern corporate governance issues for SROs and, as such, the commenter's remarks would more effectively be made in a comment to the Commission's May 31, 2001 proposal on notice-designation of contract markets in security futures products and related matters.²³ The Commission would consider specific

²⁰ See *Designated Contract Markets in Security Futures Products; Notice Designation Requirements, Continuing Obligations, Applications for Exemptive Orders, and Exempt Provisions*, 66 FR 29517 (May 31, 2001).

²¹ *Proposed Regulation to Restrict Dual Trading in Security Futures Products*, 66 FR 36218 (July 11, 2001).

²² The comment with respect to Rule 1.62 is also moot, as a result of the enactment of the CFMA and the proposed new regulatory framework. See note 22, *supra*.

²³ See note 20, *supra*.

exemptive requests under Rule 41.41 as adopted with respect to the other rules mentioned by the commenter.

The other comment was a request for rulemaking regarding the obligations of national securities exchanges that list security futures to comply with the Act and Commission regulations regarding contract market responsibilities. On the same date as the commenter's letter, the Commission published in the *Federal Register* such a proposal for rulemaking.²⁴ The Commission believes that that proposal disposes of this comment.

V. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA"), 5 U.S.C. 601-612, requires that agencies, in proposing rules, consider the impact of those rules on small businesses. The rule amendments discussed herein affect persons registered under notice-registration procedures as FCMs or as IBs, and persons who are exempt from FB or FT registration pursuant to new Section 4f(a)(3). The Commission has previously established certain definitions of "small entities" to be used by the Commission in evaluating the impact of its rules on such entities in accordance with the RFA.²⁵ The Commission previously determined that registered FCMs are not small entities for the purpose of the RFA.²⁶ With respect to IBs, the Commission has stated that it would evaluate

²⁴ *Ibid.*

²⁵ 47 FR 18618-21 (April 30, 1982).

²⁶ 47 FR at 18619-20.

within the context of a particular rule proposal whether all or some affected IBs would be considered to be small entities and, if so, the economic impact on them of any rule.²⁷

The amendments, adoption of which is announced herein, do not impose any new burdens upon persons registered as FCMs or IBs pursuant to the notice registration procedure of new Section 4f(a)(2) and persons who are exempt from FB or FT registration pursuant to new Section 4f(a)(3). Rather, these amendments establish procedures for requesting additional exemptive relief from provisions of the Act and/or the Commission's regulations for such persons. Consequently, the Commission believes that these rule amendments will in many cases reduce the burden of compliance by persons notice-registered as FCMs or IBs and persons who are exempt from FB or FT registration pursuant to new Section 4f(a)(3). Although the Commission specifically sought comments regarding the impact this rule may have on small entities, none were received.

B. Paperwork Reduction Act

New Rule 41.41 contains information collection requirements. As required by the Paperwork Reduction Act of 1995,²⁸ the Commission submitted a copy of the proposed rules to the Office of Management and Budget for its review. No comments were received in response to the Commission's invitation in the proposed rules to comment on any potential paperwork burdens associated with this regulation.

C. Cost-Benefit Analysis

²⁷ 47 FR at 18618, 18620.

²⁸ 44 U.S.C. 3501, *et seq.*

Section 119 of the CFMA amended Section 15 of the Act to require that the Commission, before promulgating a regulation under the Act or issuing an order, consider the costs and benefits of the Commission's action in light of five criteria.²⁹ The main considerations relevant to this rule are the first two considerations set forth in the Act, "protection of market participants and the public" and "efficiency, competitiveness and financial integrity of the futures markets." The Commission notes that the CFMA specifically mandates that procedures be established by which notice-registered FCMs and IBs and persons exempt from registering as FBs or FTs may seek orders granting additional exemptive relief beyond that specifically granted by the CFMA to such persons. The Commission has patterned Rule 41.41 on existing procedures, and in response to a commenter's request, has provided in the final rule that a national securities exchange or other securities industry self-regulatory organization may make an application under the rule on behalf of its members, potentially saving resources and expenses of both applicants and Commission staff. Accordingly, in adopting Rule 41.41 to establish the procedures required by Congress, the Commission has endeavored to minimize any costs incurred by those seeking the exemptive relief permitted by the CFMA.

Lists of Subjects

17 CFR Part 41

Customer protection, record keeping, required reports, dispute resolution.

²⁹ These considerations include: (A) protection of market participants and the public; (B) efficiency, competitiveness, and financial integrity of futures markets; (C) price discovery; (D) sound risk management practices; and (E) other public interest considerations.

17 CFR Part 140

Authority delegations.

For the reasons stated in the preamble, the Commission hereby amends Chapter I of Title 17 of the Code of Federal Regulations as follows:

PART 41 – SECURITY FUTURES PRODUCTS

1. The authority citation for Part 41 is amended to read as follows:

Authority: 7 U.S.C. 6f and 12a.

2. Section 41.1 is amended to read as follows:

§ 41.1 – 41.40 [Reserved.]

3. Section 41.41 is added to read as follows:

§ 41.41 Application for an Exemptive Order Pursuant to Section 4f(a)(4)(B) of the Act.

(a) Any futures commission merchant or introducing broker registered in accordance with the notice registration provisions of §3.10 of this chapter, or any broker or dealer exempt from floor broker or floor trader registration pursuant to Section 4f(a)(3) of the Act, may apply to the Commission for an order pursuant to Section 4f(a)(4)(B) of the Act granting exemption to such person from any provision of the Act or the Commission's regulations other than Sections 4c(b), 4c(d), 4c(e), 4c(g), 4d, 4e, 4h, 4f(b), 4f(c), 4j, 4k(1), 4p, 6d, 8(d), 8(g), and 16 of the Act and the rules thereunder.

(b) An application pursuant to this section must set forth in writing or in an electronic mail message the following information:

(1) The name, main business address and main business telephone number of the person applying for an order;

(2) The capacity in which the person is registered with the Securities and Exchange Commission and the person's CRD number (if a member of the National Association of Securities Dealers, Inc.) or equivalent self-regulatory organization identification, together with a certification, if true, that the person's registration is not suspended pursuant to an order of the Securities and Exchange Commission;

(3) The particular section(s) of the Act and/or provision(s) of the Commission's regulations with respect to which the person seeks exemption;

(4) Any provision(s) of the securities laws or rules, or of the rules of a securities self-regulatory organization analogous to the provision(s);

(5) A clear explanation of the facts and circumstances under which the person believes that the requested exemptive relief is necessary or appropriate in the public interest; and

(6) A clear explanation of the extent to which the requested exemptive relief is consistent with the protection of investors.

(c) A national securities exchange or other securities industry self-regulatory organization may submit an application for an order pursuant to this section on behalf of its members.

(d) An application for an order must be submitted to the Director of the Division of Trading and Markets, Commodity Futures Trading Commission, 1155 21st Street, N.W., Washington, D.C. 20581, if in paper form, or to tm@cftc.gov if submitted via electronic mail.

(e) The Commission may, in its sole discretion, grant the application, deny the application, decline to entertain the application, or grant the application subject to one or more conditions.

Part 140 – Organization, Functions, and Procedures of the Commission.

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

Authority: 7 U.S.C. 2 and 12a.

5. Section 140.91 is amended by reserving subparagraph (a)(7) and by adding new subparagraph (a)(8) to read as follows:

§ 140.91 Delegation of Authority to the Director of the Division of Trading and Markets.

(a) * * *

(7) [Reserved.]

(8) All functions reserved to the Commission in §41.41 of this chapter. Any action taken pursuant to the delegation of authority under this paragraph (a)(8) shall be made with the concurrence of the General Counsel or, in his or her absence, a Deputy General Counsel.

* * * * *

Issued in Washington, D.C. on _____, 2001, by the Commission.

Jean A. Webb,
Secretary of the Commission