

**CFTC Letter No. 00-80****June 30, 2000****No-Action****Division of Trading & Markets**Re: Electronic Commodities Trading Platform

---

Dear :

This is in response to your letter dated June 5, 2000 to the Division of Trading & Markets and the Division of Economic Analysis of the Commodity Futures Trading Commission (the "Commission"), on behalf of your client, "X", as supplemented by additional correspondence, meetings and telephone conversations.

In your letter of June 5, 2000 you seek confirmation that the Division of Trading & Markets and the Division of Economic Analysis will not recommend that the Commission take enforcement action under the Commodity Exchange Act, 7 U.S.C. § 1 *et seq.* (the "Act"), or the regulations thereunder, in connection with (i) the operation by "X" of a proposed electronic platform (the "Platform") for the trading of physical commodities and derivatives products, (ii) any transactions executed through the Platform, or (iii) any participants in such transactions. In accordance with our discussions, the Division of Trading & Markets (the "Division") is responding to your request.

***Facts***

Based upon the representations made by and on behalf of "X" in written correspondence, meetings and telephone conversations with Commission staff, we understand the facts to be as follows:

"X" is a Delaware limited liability company. You have represented that none of the persons who are 10%-or-more interest holders, members of the Board of Managers or senior officers of "X" is subject to any of the statutory disqualifications from registration listed in Sections 8a(2) or 8a(3) of the Act, 7 U.S.C. §§ 12a(2) and 12a(3).<sup>1</sup> You have further represented that "X" will impose and enforce requirements that its board members and senior executives satisfy specified fitness criteria, including that such persons are not subject to any statutory disqualifications under Sections 8a(2) or 8a(3) of the Act. You have provided a written representation to the effect that "X" will endeavor to prevent, and will by its policies prohibit, any director, officer, employee or agent who may, in the performance of his or her duties, gain access to material nonpublic information regarding the users of, bids and offers made on, or transactions executed through the Platform, from (i) trading for such person's own account or on behalf of any other account in commodities, commodity futures contracts, options on commodity futures contracts or other commodity derivatives, on the basis of such material nonpublic information, and (ii) disclosing for any purpose inconsistent with the performance of such person's official duties any such material nonpublic information. In relation to this, you have further represented that "X" will endeavor to provide access to material nonpublic information only to such of its directors, officers, employees and agents who require such access in the performance of their duties.

"X" is in the process of developing the Platform for the purpose of trading physical commodities and derivative products. It intends that the Platform initially will offer trading in physical and derivative products relating to the following energy commodities: crude oil, heating oil, unleaded gasoline and jet kerosene. Later, the product offerings of the Platform may be expanded to include other commodities.<sup>2</sup> Among the derivative products to be traded through the Platform will be

"swap agreements," as defined in Commission Rule 35.1, relating to physical commodities.

The Platform will be available only to approved participants that satisfy specified criteria which are designed to limit participants to commercial entities.<sup>3</sup> In particular, participants will be limited to those "eligible swap participants" that are commercial entities and are encompassed within subsections (i), (ii), (iii), (vi) or (viii) of Commission Rule 35.1(b).<sup>4</sup> For this purpose, a "commercial entity," with respect to a given product, is defined to include (i) any entity that, in connection with its business, makes and takes delivery of the underlying physical commodity and regularly incurs risks related to such commodity, and (ii) any entity that, as a substantial portion of its business, regularly provides hedging, risk management or market-making services to entities encompassed within (i) above.<sup>5</sup> As an additional matter, commercial entities will be permitted to enter into transactions through the Platform only as principals, and not as intermediaries on behalf of third parties.

"X" proposes to permit participants to designate brokers who will be authorized to access the Platform for the purpose of monitoring the market and/or entering orders for transactions on behalf of such participants. The procedure for designating brokers is set forth in the User Manual (a copy of which you have provided to us). Brokers will not have the right to access the Platform for the purpose of entering into transactions on their own behalf. Brokers will enter orders as if they were the participant on whose behalf they act, *e.g.*, the credit checks that are in place will reflect the credit of the participant, and the identity revealed to a counterparty following a match will be that of the participant.

The Platform will be password-protected and will be accessible only by participants and brokers acting on their behalf. Each participant will be required to identify those other participants that it has approved as counterparties. The approval of other participants as counterparties, however, as well as the standards to be applied in making such determinations (which may include credit or other considerations), will be left to each participant in its discretion. The Platform will then employ "filters" to ensure that each participant enters into transactions only with those other participants that it has approved as counterparties.

Each participant will be permitted to post on the Platform bids and offers for transactions relating to various commodities and derivatives on such commodities. If another participant enters an opposite bid or offer, and the posting participant has approved such other participant as a counterparty, a transaction will result with the posting participant at the specified price. If a participant has not been approved as a counterparty by the posting participant, such participant will see an indicator reflecting the fact that the bid or offer is not available to it. Each participant posting bids or offers, therefore, will be making such quotations available only to those other participants that it has approved as counterparties.

The Platform will utilize an electronic trading and matching system that participants will access through the Internet or through dedicated communications lines that will allow participants to post bids and offers on a real-time basis. During its initial roll-out, the Platform may be available for trading only during limited periods of time. Eventually, however, "X" intends to make the Platform available on a 24-hour, 5-day per week basis (subject to maintenance requirements and prevailing market conventions). The technology to be utilized by the Platform will provide all participants (subject to approval of their credit by the posting participants) with fair and impartial access to posted bids and offers and no preferential access will be afforded to any participants. Bids and offers will be matched based on time and price priority. The Platform will provide a blotter for each participant or sub-groups within such participant, which will display completed transactions, as well as tools to view, withdraw and add orders. All orders will be capable of being withdrawn from the market at any time before a match is completed.<sup>6</sup>

A participant will be able to install the necessary software by downloading it from the Internet and/or installing it from a compact disk. The software will protect confidentiality using standard Internet Secure Sockets Layer (SSL) encryption. As noted, the Platform will be accessible only through passwords and will not be available to the general public or to any parties other than participants and their brokers.

Counterparty names will be released to each of the parties to a transaction immediately following a match executed through the Platform, and trade summaries will automatically be posted to each counterparty's "Position Manager" window, as provided in the User Manual. Any transactions executed as a result of bids or offers posted on the Platform will be entered into exclusively between the two parties to the transaction. Moreover, each participant will be responsible for entering into bilateral documentation with each other participant with which it trades, and for negotiating and enforcing credit and other material terms including appropriate payment and delivery arrangements. The Platform, therefore, will serve as a vehicle for executing transactions based on posted bids and offers and will not be involved in any manner in credit matters or the payment and delivery functions.

With respect to its technical operations, "X" has provided Commission staff with a tour of the facility housing the hardware for the Platform. During this on-site visit, "X" representatives explained the Platform architecture and demonstrated how the Platform will operate on the Internet. The Platform is based on a client-server architecture. It provides a high level of performance and reliability through the use of redundant components and automatic load balancing. The hardware is housed in a state-of-the-art secure facility designed to protect against physical disasters. "X" representatives fully described the functional capabilities of the Platform and the operation of the price-time priority trade matching algorithm. They also demonstrated the Platform's logical security and its ability to maintain the integrity of its data. "X" representatives described and demonstrated the software tools and procedures that enable them to effectively control internal changes to hardware and software. They also described an adequate technical support program for users, developers and operators. Commission staff have reviewed the test methodologies employed for functional and capacity testing and have found them and the test results to be satisfactory. In providing the foregoing and other information, "X" representatives explained how the Platform meets the Principles for the Oversight of Screen-Based Trading Systems for Derivative Products developed by the Technical Committee of the International Organization of Securities Commissions (the "IOSCO Principles").<sup>7</sup>

"X" has established the terms and conditions for all trading conducted through the Platform, including, but not limited to, the eligibility criteria for participants in the Platform, the procedures for posting bids and offers, and the obligations of participants with respect to matched transactions. Participants will be provided with disclosure of all material aspects of the operation of the Platform and of the terms and conditions of trading. The Platform will record and maintain detailed records of all transactions executed through the Platform. In the event that participants are found not to be in compliance with the terms and conditions, "X" will be authorized to take appropriate action, including suspensions of or limitations on access to the Platform, or the complete termination of access. The Platform will provide to participants information regarding prices, bids and offers and other appropriate matters. With respect to actively traded products, the Platform will undertake to make available to the public information regarding price ranges and daily volumes as well as other relevant information.<sup>8</sup>

### *Discussion*

The Division has reviewed your representations regarding the operation of the Platform. In our view, granting your request would be consistent with the overall policies of the Act and Commission exemptions thereto.<sup>9</sup>

Accordingly, the Division will not recommend that the Commission take any enforcement action against the Platform, its owners and operators or any of its participants based solely on the operation of the Platform or the execution of transactions thereon as described above. The Division believes that relief is appropriate in light of the representations that have been made in your letter, as supplemented by additional correspondence, meetings and telephone conversations, including representations that "X" will provide the Commission, upon its request, with additional information concerning the terms and conditions of trading, fitness criteria compliance, and the operation of the Platform, and that it will provide Commission representatives with access to the books and records of the Platform.<sup>10</sup> "X" has further represented that, following the issuance of this letter, it will promptly notify the Commission of any material change in the facts and

circumstances as represented, including any material change in the User Agreement or User Manual.

Additionally, based on information provided to us in connection with the Commission staff's technology site visit and otherwise, the Division has determined that the Platform adequately addresses the IOSCO Principles. As a result, for purposes of granting the relief provided herein, the Division has concluded that "X" need not obtain a comprehensive third party review of the Platform technology. Rather, it is sufficient that "X" obtain a third party expert review limited to the Platform's vulnerability to denial-of-service attacks, which is an area that both Commission staff and "X" believe warrants further attention. **To this end, "X" has represented that it intends to engage an independent third party to conduct such a review, and that a copy of the results of this review will be provided to the Division within 120 days from the date of this letter.**

**This no-action position is based on our understanding of the facts as represented to us. Any different, changed or omitted material facts might render this position void. Moreover, this letter does not address whether, and "X" does not concede, (i) that the Platform will be a multilateral transaction execution facility for purposes of Part 35 of the Commission's regulations, or (ii) that transactions executed through the Platform will constitute futures contracts. The no-action position taken herein is solely that of the Division and does not necessarily represent the views of the Commission or those of any other division or office of the Commission. The terms and conditions of this letter and the operation of the Platform might require modification to reflect any applicable rules that the Commission might adopt in this area.**

**If you have any questions concerning this matter, please contact Phyllis Dietz, an attorney on my staff, at (202) 418-5430.**

Very  
truly  
yours,

John C.  
Lawton  
Acting  
Director

**1 You have provided us with background information concerning the 10%-or-more interest holders, members of the Board of Managers and senior officers. In this regard, we note that certain of the individuals holding such positions have substantial experience in markets for physical commodities and derivative products.**

**2 Your letter expressly states that the physical commodities and derivatives products traded on the Platform will not involve any of the agricultural commodities enumerated in Section 1a(3) of the Act, 7 U.S.C. § 1a(3).**

**3 These criteria are set forth in the User Agreement, a copy of which you have provided to us.**

**4 In addition, the User Agreement expressly excludes participation by (i) private investment companies operating pursuant to Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, (ii) private investment companies organized under the laws of a non-U.S. jurisdiction, and (iii) natural persons.**

**5 Participants also may execute transactions for which the underlying commodity has a reliable and demonstrable price relationship to a commodity that is otherwise identified with respect to criteria (i) or (ii) above.**

**6 Orders may not be modified once they are entered. To effect a change, a participant must cancel the order and**

then re-enter it with the desired changes.

**7 The IOSCO Principles were adopted by IOSCO on November 15, 1990, and set out in broad terms the international consensus as to the regulatory considerations to be addressed in reviewing mechanisms for cross-border screen-based trading. The Commission adopted the IOSCO Principles as a statement of regulatory policy for the oversight of screen-based trading systems for derivative products on November 21, 1990. See Policy Statement Concerning the Oversight of Screen-Based Trading Systems, 55 Fed. Reg. 48,670 (Nov. 21, 1990).**

**8 "X" and the Division have agreed to have further discussions regarding public availability of trading information.**

**9 See also Commission Staff Letter No. 00-64 (May 8, 2000).**

**10 The User Agreement gives notice to participants that "X" intends to provide the Commission with access to transaction information, including the identity of parties to a particular transaction, as may be requested by the Commission. We also note that "X", with respect to audit trail data, has provided sample screens and described various ways in which requested data can be sorted and made available to the Commission.**