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U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5100
Facsimile: (202) 418-5521

OFFICE OF THE
SECRETARIAT

MEMORANDUM

TO: The Commission

FROM: Jean Webb, Secretary of the Commission

RE: Staff Document for November 17, 1999 -- Notice of Final Rulemaking--
"Revised Procedures for Listing New Contracts"

DATE: November 16, 1999

Please replace the attached revised document in the above matter with the document previously distributed.

ATTACHMENT

U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5260
Facsimile: (202) 418-5527

DIVISION OF
ECONOMIC ANALYSIS

November 9, 1999

11/12/99 mtg

MEMORANDUM

TO: The Commission

FROM: Division of Economic Analysis

SUBJECT: Notice of Final Rulemaking—"Revised Procedures for Listing New Contracts"

RECOMMENDATION: That the Commission publish in the *Federal Register* the attached notice of final rulemaking

CONSULTED: Division of Trading and Markets
Office of the General Counsel
Division of Enforcement
Office of the Executive Director

For the reasons explained therein, the Division of Economic Analysis recommends that the Commission publish in the *Federal Register* the attached notice of final rulemaking. This final rule permits the exchanges to list contracts for trading without Commission approval. Specifically, in July of this year, the Commission proposed a two-year pilot program to permit the listing of contracts for trading prior to Commission approval. 64 FR 40528 (July 27, 1999). This final rule modifies the proposed rule by permitting the exchanges to list commodity futures or option contracts for trading without Commission approval of the contract or its terms and conditions, including any subsequent amendments thereto. This new listing procedure is an alternative to regular or fast-track procedures for contract market designation.

This final rule is a "rule" for purposes of Congress' review of agency rulemaking as set forth in 5 U.S.C. §801 *et seq.* but does not fall within the meaning of the term "major rule" as defined by 5 U.S.C. §804(2).[1] Accordingly, we recommend that the

[1] A "non-major rule" becomes effective as proposed by an agency if Congress and GAO have received the required report. A "major rule" will generally become effective 60 days after Congressional receipt of an agency's report. The Division is recommending a general effective date of 60 days after publication in the *Federal Register* for this rule.

Commission determine that this rule is not a "major rule." In authorizing the publication of this release, the Commission will be making such a determination. A copy of the rule and a brief report will be submitted to each House of Congress and the General Accounting Office (GAO) upon the Commission's adoption of the rule.[2]

Paul Architzel (ext. 5267)

Attachment

The Office of Information and Regulatory Affairs (OIRA) within the Office of Management and Budget is authorized to make the determination as to whether a rule is considered "major" but does not specify when such determination is to be made. Nor does the new law require that an agency certify in its required report to Congress and GAO that OIRA had concurred with its initial determination as to whether a rule is a "major rule."

Section 804(2) defines "major rule" as a rule resulting in or likely to result in:

(A) An annual effect on the economy of $100,000,000 or more;

(B) A major increase in costs or prices for consumers, individual industries, Federal, State, or local government agencies, or geographic regions; or

(C) Significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign based enterprises in domestic and export markets.

[2] OIRA will also be notified of the Commission's regulatory action and its determination that this rule is not a "major rule."

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 5

Revised Procedures for Listing New Contracts.

AGENCY: Commodity Futures Trading Commission

ACTION: Final Rules

SUMMARY: The Commodity Futures Trading Commission (Commission) is adopting a final rule permitting exchanges to list contracts for trading without Commission approval. In response to continued expressions of industry concern that the ability to list new contracts for trading without delay is vital to the exchanges' continued competitiveness, the Commission proposed a two-year pilot program to permit the listing of contracts for trading prior to Commission approval. 64 FR 40528 (July 27, 1999). Based upon the comments received, the Commission is modifying the proposed rule to permit exchanges to list commodity futures or option contracts for trading without Commission approval of the contract or its terms and conditions, including any subsequent amendments thereto. This new listing procedure is an alternative to regular or fast-track procedures for contract market designation. To meet its statutory mission of ensuring market integrity and customer protection, the Commission will place greater reliance on its existing oversight authorities to disapprove, alter or supplement exchange rules or to take emergency action, as appropriate. The Commission also is making a number of technical changes to the rule, as suggested by the comments.

In a companion release published elsewhere in this edition of the Federal Register, the Commission is proposing to permit all exchange rules and rule amendments to be made effective without Commission approval. As part of that proposed rulemaking, the Commission will seek comment on whether the new procedure for listing contracts for trading without approval which the Commission is adopting herein should become the exclusive means of offering new exchange products and amending their terms and conditions. In a second companion notice in this issue of the Federal Register, the Commission is also proposing to delete fees for applications for contract market designation in order to remove any economic disincentive for using regular or fast-track review procedures.

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

FOR FURTHER INFORMATION CONTACT: Paul M. Architzel, Chief Counsel, Division of Economic Analysis, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, D.C. 20581, (202) 418-5260, or electronically, [PArchitzel@cftc.gov].

SUPPLEMENTARY INFORMATION:

I. The Proposed Rules

The Commission recently proposed rules to enable boards of trade to list for trading new contracts[1] without any waiting period. 64 FR 40528 (July 27, 1999). This proposal responded to testimony of representatives of U.S. exchanges that the ability to list contracts more quickly than currently possible is necessary for them to meet competitive challenges by foreign exchanges.[2] The proposed rule, pursuant to the Commission's 4(c) exemptive authority, provided that boards of trade already designated as a contract market in one commodity could list new contracts for trading while their application for designation in the contract was pending approval. Thus, the proposed rules responded to the need for immediacy in listing new contracts within the current statutory framework which requires that the Commission designate boards of trade as a contract market in a commodity and that the Commission approve that contract's terms and conditions.[3]

Specifically, the proposed rule would have required boards of trade to file a contract's terms and conditions with the Commission by close of business on the business day prior to, and

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[1] However, the Commission proposed that contracts subject to the accord provision of section 2(a)(1)(B) of the Commodity Exchange Act (Act) not be eligible for this relief, consistent with the provisions of section 4(c) of the Act.

[2] During hearings before the Subcommittee on Risk Management and Specialty Crops of the House Committee on Agriculture, representatives of four U.S. futures exchanges testified that the current regulatory structure is overly burdensome and that statutory changes are necessary to achieve "parity" with foreign exchanges and to better enable U.S. exchanges to compete in the growing global marketplace. CFTC Reauthorization: Hearings Before the Subcommittee on Risk Management and Specialty Crops of the House Committee on Agriculture, 106th Cong., 1st Sess. (1999). See, statements of the Chicago Board of Trade, the Board of Trade of the City of New York, the Chicago Mercantile Exchange, and the New York Mercantile Exchange (NYMEX).

In particular, the U.S. exchanges urged Congress to eliminate the requirement that the Commission review and approve new contracts before they begin trading and amendments to exchange rules before they can be implemented. For example, Daniel Rappaport, Chairman of the Board of Directors of NYMEX testified that, "detailed CFTC review and approval of the specific terms and conditions of the contract has not been necessary, provides marginal, if any value, and adds cost, uncertainty, and delay to the roll-out of new contracts."

[3] As the Commission noted, although the contracts during that initial listing period would not have been designated, they would have been designated subsequently using the current procedures, including fast-track review. During the initial review period, the contracts would have been valid and enforceable pursuant to the Commission's rule which was proposed under the Commission's exemptive authority. Id. at 40531.

an application for contract market designation within forty-five days of, initially listing a contract for trading. Boards of trade would have been permitted to list and maintain up to a full year's trading months prior to designation. Finally, they would have been required to identify the contract as listed pending Commission designation, to enforce the contract's terms and conditions, and to fulfill all of a contract market's self-regulatory obligations during the period prior to its designation as a contract market in that commodity. The proposed rule also provided that while a designation application submitted under regular or fast track procedures was pending, a second exchange could not list the same, or a substantially similar, contract to trade under the rule, nor could the listing procedure be used to evade an adverse Commission proceeding involving the same or a substantially similar contract.[4]

II. Comments received

Seven entities commented on the proposed rule-- five futures exchanges, a futures industry association and an association representing commodity merchandisers.[5] The exchanges generally commented that the proposed rule did not provide sufficient relief. They unanimously opposed the Commission designating a contract after it has been listed for trading, advocating instead that the Commission limit its role to disapproving a new contract or requiring its terms to be amended. They also opposed limiting to one year the trading months that initially could be

[4] Accordingly, where the Commission has initiated a proceeding to alter an exchange rule under section 8a(7) of the Act, to disapprove a proposed or existing contract term or condition under section 5a(a)(12) of the Act, to alter or change delivery points or commodity or locational differentials under section 5a(a)(10) of the Act or to disapprove an application for designation or suspend a designation under section 6 of the Act, or any similar adverse action, an exchange could not list a "new" contract for trading and thereby frustrate the proceeding against, or evade application of the Commission's process applicable to, the original, designated contract market.

[5] The thirty-day comment period closed on August 26, 1999.

listed and the Commission characterizing the proposed rule's implementation as a "pilot program." One commenter supported the proposal. The comments are discussed in greater detail below.

Based on its administrative experience and in response to the comments received, the Commission is adopting a final rule permitting exchanges to list contracts for trading pursuant to exchange certification, and without prior Commission approval. As one exchange commenter noted, "contract approval, while arguably useful in an era before exchanges had developed [sophisticated] . . . self-regulatory systems and procedures," is no longer necessary. New York Board of Trade (NYBOT) comment letter at 3. The Commission agrees that it can, and should, place greater reliance on the exchanges' role as self-regulatory organizations, particularly in connection with their decisions to list new products for trading.

As the NYBOT points out, commodity futures and option exchanges over the years have developed increasingly sophisticated self-regulatory mechanisms and procedures to keep pace with the changing nature of the products which they offer. During that time, the Commission has kept pace with those changes by periodically updating the requirements for an application for contract market designation and its processing procedures. [6] Based on that experience, the Commission is confident that commodity futures and option exchanges stand ready to assume greater responsibility for ensuring that their new products meet the applicable statutory and regulatory requirements. The Commission is equally assured that the exchanges will return that

[6] See, Guideline No. 1, 17 CFR Part 5, Appendix A, and 17 CFR 5.1 (fast-track designation procedures.)

confidence through their cooperative response to the Commission's efforts to exercise greater oversight authority and to decrease its direct regulation.

III. The Final Rule

A. Legal Certainty

All of the commenters opposing the proposed rule cited the need for increased legal certainty. Several, such as the Chicago Mercantile Exchange (CME) and the New York Mercantile Exchange (NYMEX) opposed implementation of the rule as a two-year pilot program. They reasoned that a pilot program created undue uncertainty because there was no assurance that the rule would be continued or expanded at the end of the initial two-year period. NYMEX additionally observed that "the Commission has not provided guidance on how it would evaluate the pilot program."[7] In order to provide greater legal certainty to the market, the Commission is promulgating the rule for an unlimited duration and not as a pilot program.

All of the exchanges opposed the proposed rule's requirement that boards of trade submit to the Commission an application for contract market designation within forty-five days of listing a contract to trade. The CME reasoned that the possibility that the Commission might "disapprove the contract or require its terms to be amended . . . is likely to discourage market

[7] NYMEX comment letter at p. 3. NYMEX also suggested that the Notice of Proposed Rulemaking's description of certain benefits of Commission review of exchange rules with no "original assessment" of the costs of that review called into question the Commission's commitment to its proposed pilot program." The Commission disagrees. The proposed rule on its face either reduced or did not increase regulatory costs.

participants from trading the new contract." CME comment letter at 4. The Chicago Board of Trade (CBT) objected that,

> the Commission is expressly retaining the requirement of Commission review of contract terms, along with the concomitant authority to disapprove or require changes to the contract terms, post-listing. The risk that contract terms could change by Commission fiat during a post listing review period will discourage market use of any contract listed under the pilot program.

CBT comment letter at 2. NYMEX concluded that "uncertainty regarding whether or not a pending application for designation would be approved or denied, or perhaps modified from the original filing under terms dictated to an exchange by the CFTC, could continue for a whole year."[8] NYMEX comment letter at 3. The exchanges therefore concluded that the proposed rule would better serve their competitive needs by permitting them to "list new contracts without Commission approval—not "pending" such approval." NYBOT comment letter at 2.

The Commission, in response to the comments, is modifying the rule as proposed to replace the requirement that boards of trade submit for Commission review and approval an application for contract market designation within forty-five days of listing a contract. Instead, boards of trade only will be required to certify that the contract listed for trading meets the requirements of the Commodity Exchange Act and the Commission's rules thereunder. This certification must be filed along with the contract's terms and conditions no later than the close of business of the business day preceding the contract's listing. The exchange's certification that

[8] NYMEX's conclusion regarding the relative degree and length of any such uncertainty is based upon the assumption that the Commission would take the entire statutorily-provided time for the post-listing review and designation of new contracts. However, nothing in either the fast-track or the proposed rule would have precluded use of the Commission's fast track procedures (17 CFR 5.1), which provide either a ten or forty-five day review period. Moreover, the fast-track rule empowers exchanges to request that, if the Commission terminates fast track review, it either approve the contract as submitted or initiate disapproval proceedings.

the contract meets the statutory and regulatory requirements is in lieu of the otherwise required application for contract market designation and the Commission's review and approval of the application and of the contract's terms. Under the final rule, contracts may be listed for trading indefinitely in reliance on the exchange's certification;[9] and as discussed below the Commission generally will not review and approve the contract's terms under section 5a(a)(12) of the Act and Commission rule 1.41.

The exchange commenters also objected to the proposed requirement that they notify the public on all public references to the contract or its trading months that the contract is trading pending Commission designation. The CBT stated that, according to certain market users, highlighting the revised terms for deferred contract months in its soybean oil contract as "pending Commission approval" "discouraged calendar spread trading" and that "even though open interest began to slowly increase while [it] . . . waited for final Commission action, that growth was slower than anticipated."[10] CBT comment letter at 2. The NYMEX concurred, stating that "uncertainty regarding whether or not a pending application for designation would be approved or denied. . . could continue for a whole year," and "during that period . . . a board of trade would have a continuing duty to notify the public . . . that the contract was trading pending Commission designation." NYMEX comment at 3.

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[9] The exchanges also commented that the proposed limitation of delivery months which could be listed prior to designation to one rolling year would discourage trading in contracts listed under the rule. The final rule includes no limitation on the listing of distant trading months.

[10] The CBT amendments to the soybean contract raised a number of potential issues under U.S. antitrust laws which the Commission, under section 15 of the Act, was obliged to consider in approving the rule. In addition, the Commission found it necessary to amass a sizeable administrative record to determine the relative merit of the claims of non-members of the exchange opposed to the CBT's amendment.

However, as long as boards of trade have available two means of listing contracts, either by self-certification or Commission approval, the public has a right to know the legal status of a contract. The final rule clarifies that this public notice obligation is satisfied through an appropriate reference in the board of trade's rule book and includes other conforming changes. Accordingly, the Commission is adopting as final a requirement that the board of trade identify the contract in its rules as "listed for trading pursuant to exchange certification."

Two commenters suggested that trading in contracts listed pursuant to the rule would be discouraged without greater legal certainty that a subsequent Commission finding disapproving or altering a contract term would not also invalidate open contracts. As the Futures Industry Association (FIA) noted:

> although the Commission states in the *Federal Register* release accompanying the proposed rule that any contract listed under the revised procedures would be valid and enforceable pending approval, the proposed rule itself is silent on this issue Without such certainty, the enforceability of any contract subsequently determined to be in violation of the Act would also be open to question.

FIA comment letter at 2. The NYBOT concurred in this view. NYBOT comment letter at 3. Others informally have expressed the view that the applicability of the Act would be uncertain legally unless contracts which are "listed pursuant to exchange certification" were also deemed to be "designated contract markets" under the Act. The final rule addresses both of these concerns.

The final rule, in response to these comments, explicitly preserves the validity and enforceability of contracts listed pursuant to exchange certification despite a possible violation of the rule by the listing board of trade. For example, if a board of trade incorrectly certifies that

the terms of a contract that it is listing for trading do not violate the Act, it will be subject to Commission remedial action for that violation. However, the individual contracts that have been traded are valid and enforceable nonetheless.[11] The Commission in the final rule also has made explicit that all sections of the Act and Commission rules which refer to "designated contract markets" are applicable to contracts listed for trading pursuant to rule 5.3.[12]

Accordingly, in exempting boards of trade from the designation and rule approval requirements of the Act, the Commission is not thereby ceding any of its broad oversight authorities over designated contract markets. These include, among others, its authority to disapprove, alter or supplement contract rules under sections 5a(a)(12)[13] and 8a(7)[14] of the Act

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[11] Similarly, although the Commission found that the CBT corn and soybean futures contract markets violated the provisions of section 5a(a)(10) of the Act, the individual contracts traded were valid, enforceable contracts.

[12] Compare, 17 CFR 33.2.

[13] Section 5a(a)(12) of the Act provides in part that:

> the Commission shall disapprove, after appropriate notice and opportunity for hearing, any such rule which the Commission determines at any time to be in violation of the provisions of this Act or the regulations of the Commission. If the Commission institutes proceedings to determine whether a rule should be disapproved pursuant to this paragraph, it shall provide the contract market with written notice of the proposed grounds for disapproval, including the specific sections of this Act or the Commission's regulations which would be violated. At the conclusion of such proceedings, the Commission shall approve or disapprove such rule. Any disapproval shall specify the sections of this Act or the Commission's regulations which the Commission determines such rule has violated or, if effective, would violate.

The Commission is not waiving in any way its authority under section 5a(a)(12) to disapprove "at any time" a rule of a contract which has been listed for trading pursuant to this exemption.

[14] Section 8(a)(7) of the Act provides in part that the Commission is authorized:

> to alter or supplement the rules of a contract market insofar as necessary or appropriate by rule or regulation or by order, if after making the appropriate request in writing to a contract market that such contract market effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the Commission determines that such contract market has not made the changes so required, and that such changes are necessary or appropriate for the protection of persons producing, handling, processing, or consuming any commodity traded for future delivery on such contract market, or the product or byproduct thereof, or for the protection of traders or to insure fair dealing in

and its section 8a(9) authority to direct a contract market to take action in market emergencies.[15] The Commission has used these authorities sparingly in the past.[16] In light of the futures exchanges' steadfast commitment to fulfilling their self-regulatory responsibilities, the

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commodities traded for future delivery on such contract market. Such rules, regulations, or orders may specify changes with respect to such matters as--

(A) terms or conditions in contracts of sale to be executed on or subject to the rules of such contract market; (B) the form or manner of execution of purchases and sales for future delivery; (C) other trading requirements, excepting the setting of levels of margin; (D) safeguards with respect to the financial responsibility of members; (E) the manner, method, and place of soliciting business, including the content of such solicitations; and (F) the form and manner of handling, recording, and accounting for customers' orders, transactions, and accounts;

The Commission is not in any way waiving its authority to alter, supplement or amend a rule of a contract that has been listed for trading pursuant to this exemption.

[15] Section 8a(9) of the Act provides in part that the Commission is authorized:

to direct the contract market, whenever it has reason to believe that an emergency exists, to take such action as in the Commission's judgment is necessary to maintain or restore orderly trading in or liquidation of any futures contract, including, but not limited to, the setting of temporary emergency margin levels on any futures contract, and the fixing of limits that may apply to a market position acquired in good faith prior to the effective date of the Commission's action.

The Commission is not in any way waiving its authority to declare a market emergency in a contract which has been listed for trading pursuant to this exemption and to order appropriate remedial measures.

[16] The CME maintains that a new standard for rule disapproval is necessary. It suggests that an exchange rule be subject to disapproval only when the rule "is likely to cause fraud, render trading readily susceptible to manipulation, or threaten the financial integrity of the market." CME comment at 6. However, under section 5a(a)(12) of the Act, exchange rules are subject to disapproval if they are in "violation of the provisions of this Act or the regulations of the Commission." This standard is far less ambiguous than the one proposed by the CME. Moreover, in light of the limited number of times that the Commission has in fact instituted a proceeding to disapprove or alter a rule, the CME's fear that the Act's current disapproval standard has been , or is, subject to overuse, is misplaced. Moreover, the CME points to the Commission's process for approving an increase to the tick size of the E-Mini S&P 500 contract as an example of Commission micromanagement and why a new standard for disapproval is warranted. Reliance on that example is also misplaced. The Commission's review and request for public comment was triggered by section 15 of the Act and the potential anti-trust implications of increasing the contract's tick size. However, if a contract is not submitted for Commission approval, potential anti-trust issues involving its terms and conditions generally would not be considered by the Commission.

Commission anticipates that despite the absence of its affirmative prior review of exchange contracts and rules, such adverse actions will continue to be infrequent.[17]

B. Approval of contract terms and conditions

Currently, the Commission approves a contract's initial terms and conditions under section 5a(a)(12) of the Act and Commission rule 1.41 when it issues an Order designating a board of trade as a contract market in that commodity. The Commission also reviews and approves all amendments to the contract's terms and conditions. As proposed, rule 5.3 would have preserved this framework by requiring the exchange to file an application for designation after the contract initially was listed for trading. Filing an application for designation would have triggered the Commission's authority to review and approve the contract's terms and conditions as well as any subsequent amendments. 64 FR at 40532.

As modified, the final rule permits a board of trade indefinitely to list a contract for trading under its provisions. Accordingly, the final rule does not require that an application for contract market designation be submitted to the Commission. Consistent with that provision, a contract listed pursuant to the rule will not have its initial terms and conditions approved by the Commission.[18]

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[17] Section 8c(a)(1) of the Act provides the Commission with the authority to discipline directly any exchange member if the exchange, as the self-regulator, fails to act. The Commission is not waiving this oversight authority in any way.

[18] However, the Commission on its own initiative and in its sole discretion may review and approve certain exchange rules, such as exchange speculative position limits, when Commission approval would be in the public

However, as the Commission noted in the Notice of Proposed Rulemaking, contract amendments may raise additional issues for Commission review, such as their potential

> impact on open positions. They may affect the economic utility of contracts. Moreover, exchange rule changes may be the subject of divergent interests or, potentially, conflicts of interest at an exchange or raise broad public policy issues . . . .

64 FR 40528. Nevertheless, the exchange commenters suggested that amendments to contract terms and conditions be accorded the same treatment as newly listed contracts. As the NYBOT stated, "if a new contract can be listed without prior approval, then rules that relate to contract terms and conditions, amendments thereto, and any other rules should likewise be allowed to become effective immediately upon filing with the Commission. NYBOT Comment letter at 4.

The Commission is modifying the final rule to permit boards of trade to amend the terms of a contract listed for trading by exchange certification on the same conditions that apply to its initial listing. As proposed, all contract terms and conditions would have been subject to Commission review and approval soon after the contract's initial listing. The proposed requirement that the Commission also approve contract amendments was consistent with that framework. However, because under the final rule a contract's initial terms no longer will be approved by the Commission, significant public confusion would ensue were the Commission to retain authority to approve contract amendments. That inconsistency could result in Commission approval of only the amendments to a contract term, but not of the underlying exchange rule

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interest. The Commission is empowered under section 4a(5) of the Act to enforce exchange speculative position limits which it has "approved." This authority is an important enforcement tool in cases where the violation is by a non-member of an exchange. Accordingly, the Commission may determine to approve some, or all, of the speculative position limits of contracts trading pursuant to this rule. Commission review and approval of such an exchange rule, however, would require no action by, and place no burden on, the board of trade.

itself. Moreover, had the Commission in the final rule retained the proposed requirement that contract amendments be subject to Commission pre-approval while initial contract terms were not, simply listing an amended contract as a new one would provide a ready means to bypass the requirement.[19]

Accordingly, the Commission is modifying the final rule from the rule as proposed to make consistent the regulatory treatment and status of the contract's initial terms and any amendments thereto. Thus, the final rule provides that the text of a contract amendment be submitted to the Commission by close of business of the business day preceding its being implemented. The board of trade must also submit its certification that the rule amendment does not violate and is not inconsistent with any provisions of the Commodity Exchange Act or the rules thereunder.[20]

In addition, the final rule requires that amendments to the terms and conditions of contracts trading pursuant to exchange certification be implemented only for contract months having no open interest. That implementation practice generally has been required by the Commission when reviewing proposed exchange rules for its approval to provide traders with

[19] It is not unusual for contract markets currently to list for simultaneous trading an "A" and a "B" contract when substantial amendments to a contract's terms have been made and the board of trade wishes to list nearby trading months with the amended contract terms.

[20] Proposed rule 5.3 (c) provided that boards of trade must enforce each bylaw, rule, regulation and resolution that relates to the terms or conditions of a contract listed for trading under the rule. This is to make operative section 5a(8) of the Act which requires each contract market to enforce its rules which have been approved by the Commission, which have become effective under section 5a(a)(12) of the Act or which "must be enforced pursuant to any commission rule. . . ." As self-regulatory organizations, boards of trade are expected to follow, be bound by, and to enforce their rules. This provision requires that boards of trade trading contracts pursuant to this rule adhere to this high standard. No comments specifically discussed this provision and the Commission is adopting it as final.

legal certainty regarding the contract's terms and conditions.[21] Even in the absence of rule 5.3 so requiring, boards of trade would adhere to this practice. As the NYBOT observed, "any changes to terms and conditions . . . should be made effective only with respect to contract months in which there is no open interest. This is consistent with the approach taken by the exchanges today, and endorsed by the Commission, when amendments which affect terms and conditions are introduced to existing contracts." NYBOT comment at 3.

This exemption from the requirement of prior Commission approval applies only to the amendment of contracts that are traded pursuant to rule 5.3. In a companion notice being published in this edition of the Federal Register, the Commission is proposing a similar exemption for amendments to the rules of a designated contract market. That Notice of Proposed Rulemaking raises two issues that also are applicable to these final rules. First, should the exemption specifically require that contract amendments be implemented only in delivery months with no open interest at the time the rule is made effective? Secondly, to reduce public confusion, should the Commission withdraw the availability of designation of new contracts under regular and fast-track procedures and of Commission approval of exchange rules and rule changes and make the rule 5.3 procedure the sole means of listing new contracts and amending their terms? The Commission is also proposing by separate notice in this edition of the Federal Register, to delete application fees for contract market designation. If the Commission determines to retain regular and fast-track designation procedures as alternative methods to rule

[21] The Commission has approved contract amendments for implementation in trading months with open interest only where implementation of the proposed rule change would not affect the value of existing positions or traders had notice of the impending change prior to opening their positions.

5.3 for introducing new products, retaining fees for contract market designation would operate as a disincentive to their use.

C. Conditions

The proposed rule included a number of qualifying conditions for boards of trade and the contracts to be listed thereunder. The Commission proposed that a qualifying board of trade must be designated as a contract market in at least one other non-dormant contract. The CME concurred with the proposed requirement that a board of trade already be a designated contract market in one non-dormant contract, noting that:

> start up exchanges are not appropriate candidates for the proposed pilot program because the initial designation of a board of trade as a contract market entails a more lengthy review and analysis of its trading and clearing systems and its self-regulatory programs. This restriction makes sense, and we support it.

CME comment letter at 3. The Commission is adopting this provision as final without modification.

In addition, the Commission proposed that a contract not be eligible for immediate listing under the rule if it is the same or substantially the same as one for which an application for contract designation is pending before the Commission. As it explained in the Notice of Proposed Rulemaking, the proposed restriction on listing contracts which are the same as contracts pending before the Commission for contract market designation and approval of their terms and conditions is necessary in order to avoid a "competing exchange [from] . . . short-circuit[ing] the review process and to disadvantage the exchange choosing to subject a proposed

contract to prior Commission review." 64 FR at 40531. The Commission concluded that such a use of the proposed listing procedure would have been "an unwarranted competitive use of the proposed rule." Id. The Minneapolis Grain Exchange (MGE) agreed that the "proposed rule adequately prevents attempts by exchanges to use the . . . pilot program to jump ahead of an exchange submitting the same or similar contract under regular or fast track procedures." MGE comment letter at 2.

The CME opposed the proposal. It reasoned that an exchange which is lagging in developing a new product "could file an application for contract market designation under the regular or fast track procedures, thereby preventing the exchange that is ready to list the new product sooner from using the pilot procedure to exploit its timing advantage." CME comment letter at 4-5. However, as the Commission pointed out in the notice,

> exchanges would not be able to use this proposed rule to forestall a competitor from introducing a new contract . . . . [N]othing would prevent the second exchange from filing an application for review and approval by the Commission on its own merits.

64 FR 40531, n. 19. Presumably were the second exchange really further along in developing a new contract, it would retain its timing advantage by being the first approved, while the exchange, which had filed an incomplete application preemptively, continued its contract development.[22] Accordingly, the Commission is adopting the provision as proposed. If in

[22] In this regard, fast-track approval procedures are available only for applications for contract market designation which are not amended once filed.

practice the rule is subject to the "competitive gamesmanship" postulated by the CME, the Commission will propose deleting it.[23]

The Commission also proposed that rule 5.3 not be able to be used "as a means of evading an adverse Commission proceeding involving the same or a substantially similar contract." 64 FR 40531. As the Commission explained in the Notice of Proposed Rulemaking:

> Accordingly, where the Commission has initiated a proceeding to alter an exchange rule under section 8a(7) of the Act, to disapprove a proposed or existing contract term or condition under section 5a(a)(12) of the Act, to alter or change delivery points or commodity or locational differentials under section 5a(a)(10) of the Act or to disapprove an application for designation or suspend a designation under section 6 of the Act, or any similar adverse action, an exchange could not list a 'new' contract for trading and thereby frustrate the proceeding against, or evade application of the Commission's process applicable to the original, designated contract.

Id. One commenter, the MGE, discussed this provision, noting that it "believes the Commission's proposed rule adequately prevents attempts by exchanges to use the predesignation listing to evade an adverse Commission proceeding involving the same or similar

[23] The CME also suggests that the language of the proposed rule be modified to make clear that "an exchange is not prevented from using the pilot procedure to expedite listing a new contract even though it had originally submitted the same contract to the CFTC for pre-approval under the regular or fast track procedures." CME comment letter at 4. Nothing in the Act or Commission rules prevents an exchange from withdrawing an application for contact market designation at any time. Accordingly, an exchange could have simply withdrawn its application for contract market designation and listed the contract under the rule as proposed. Nevertheless, the Commission is making explicit in the rule that this limitation applies only to a board of trade other than the one with the pending application. Of course, an exchange which abandons a pending application for contract market designation in favor of listing without Commission approval must be able to make the required certification taking into consideration any adverse information arising during consideration of the application. Moreover, in order to conserve its resources, the Commission may determine not to continue processing an application for contract market designation if it is listed for trading while the application is pending.

contract . . . ." The Commission is adopting the limitation as proposed, and notes that it applies to all boards of trade, not just to the respondent in the adverse action.[24]

Finally, rule 5.3 as proposed would not apply to futures contracts on stock indexes, commodities which are subject to the specific approval procedures of the Johnson-Shad jurisdictional accord.[25] That limitation is statutory in origin and is adopted as proposed.

IV. Section 4 (c) Findings

Commission rule 5.3 was proposed under section 4 (c) of the Act, which grants the Commission broad exemptive authority. In proposing rule 5.3, the Commission found that

> because the proposed rule applies to contracts listed on designated exchanges subject to the self-regulatory requirements of the Act, . . . all traders are 'appropriate' for application of this proposed exemptive rule. Moreover, for the reasons explained above, the Commission believes that the proposed rule would be consistent with the public interest and would not have a material adverse effect on the ability of the Commission to discharge its regulatory responsibilities or of any contract market to discharge its self-regulatory responsibilities under the Act.

64 FR 40532. The Commission specifically requested comment on its findings.

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[24] This limitation applies to all boards of trade because the Commission presumes that no exchange could make the required certification for a new contract with the same terms and conditions as one against which the Commission has initiated an adverse action. However, a competing exchange would not be estopped from listing a contract for the same commodity but which did not include the allegedly violative terms or conditions. On the other hand, the respondent exchange might be precluded from doing so if listing the revised contract were determined to be an attempt to frustrate the prosecution of the adverse action or in violation of a Commission Order issued in the course of the adverse action.

[25] See, section 2(a)(1)(B) of the Act.

The CME and the CBT both objected that the Commission should not apply the exemptive criteria of section 4(c)(2) of the Act because in their view, "the standards of Section 4(c)(1) apply to exemptive relief for existing exchanges with contract designation in place." CBT comment letter at n.1; See also, CME comment letter at n.1. However, section 4(c)(2) of the Act provides that the Commission shall grant an exemption from the requirements of section 4(a) of the Act only if certain specified conditions are met. Section 4 (a)(1) of the Act provides that to be lawful, transactions must be "conducted on or subject to the rules of a board of trade which has been designated by the Commission as a 'contract market' for such commodity." 7 U.S.C. 6(a)(1) (emphasis added). Rule 5.3 exempts boards of trade from that designation requirement. Thus, an exemption under section 4(c)(2) of the Act is necessary and its criteria for exemption must be satisfied for futures contracts to be lawfully traded on a board of trade pursuant to rule 5.3 without Commission designation in that commodity.[26] The Commission in the Notice of Proposed Rulemaking found that proposed rule 5.3 met the criteria for exemption.[27]

The FIA disagreed with the Commission's findings that the proposed rule met those criteria. It concluded that because the proposed rule "would create both practical and legal uncertainty with respect to any contract listed under the revised procedures . . . [it] question[s]

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[26] For administrative convenience, the Commission treats separately traded contracts for the same generic commodity with differing terms and conditions and pricing characteristics as separate commodities for purposes of contract market designation. See, Part 5, Appendix A, 64 FR 29221 (June 1, 1999).

[27] Section 4(c)(2) of the Act provides that: The Commission shall not grant any exemption under paragraph (1) from any of the requirements of subsection (a) unless the Commission determines that-- (A) the requirement should not be applied to the agreement, contract, or transaction for which the exemption is sought and that the exemption would be consistent with the public interest and the purposes of this Act; and (B) the agreement, contract, or transaction-- (i) will be entered into solely between appropriate persons; and (ii) will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under this Act.

whether adoption of the proposed rule 'would be consistent with the public interest.'" FIA comment letter 1. The Commission has addressed the basis for FIA's questioning whether adoption of the proposed rule would be in the public interest by modifying the final rule as recommended by FIA and the other commenters.

The Commission's section 4(c) findings were based, in part, on proposed rule 5.3's provision that, after having been listed for trading, contracts were required to be designated and their terms and conditions approved by the Commission. The Commission noted that proposed rule 5.3 would have preserved the public interest in Commission approval of new contracts and of contract amendments. That interest, it explained, arose because "appropriate contract design is the best deterrent to market manipulation, price distortion or market congestion . . . . [C]ontract approval assures that contracts meet these widely-accepted design criteria." 64 FR 40530. The Commission further noted, however, that the proposed rule was "consistent with the spirit of the Act's provision which contemplates that in certain instances exchanges may make proposed rules effective pending Commission action." 64 FR 40531.

The exchange commenters disagreed that there was a public interest in Commission designation of contracts and approval of their terms and conditions. The NYBOT countered that:

> An effective market surveillance system is the best way to avoid such market situations. Therefore, to us it is most important that an exchange has a self-regulatory track record to ensure that trading will be conducted in a fair and orderly manner. We believe the sophisticated systems developed over decades of experience, coupled with the oversight provided by the Commission, have proven to be exceptionally effective in identifying and dealing with the types of market situations which the Commission seeks to protect against. This track record strongly suggests that contract approval, while arguably useful in an era before exchanges had developed these self-regulatory systems and procedures, no longer serves any positive purpose.

NYBOT comment letter at 3. The CME concurred, stating that it did not agree with the premise that "in-depth CFTC review of new contract applications serves an important public purpose by providing an opportunity for public comment and by improving contract design." The CME explained that it agrees with those objectives, "has a strong business interest in designing its contracts so that they are not readily susceptible to manipulation" and in developing contracts "talks with commercial users." CME comment letter at 3. NYMEX argued that:

> in view of the powerful economic forces that drive exchanges to be thorough and vigilant in developing a new product, the Commission should be confident in allowing exchanges to list contracts for trading and implement rules without detailed prior review. In this regard, NYMEX finds it significant that . . . British exchanges are not currently subject to a preapproval process for their contracts and rules.

NYMEX comment letter at 4; But see, "Futures Exchange and Contract Authorization Standards and Procedures in Selected Countries," Office of International Affairs, Commodity Futures Trading Commission, August 3, 1999.

The Commission agrees with the exchanges that a strong self-regulatory program and an effective market surveillance system are necessary to remedy adverse market situations and to deter potential manipulators. However, it is generally accepted that appropriate contract design is a key component of an effective market surveillance system.[28] In this regard, exchanges have a strong business incentive to design contracts that will not be susceptible to manipulation.[29]

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[28] The view that appropriate contract design is an important component of a market surveillance program and deters manipulation, price distortion and market congestion is widely accepted internationally. See, the Tokyo Communiqué on Supervision of Commodity Futures Markets issued at the Tokyo Commodity Futures Markets Regulators' Conference on October 31, 1997.

[29] One commenter, the National Grain and Feed Association, supported proposed rule 5.3, in part, because "industry groups will still have an opportunity to comment during the formal approval process." The final rule no longer provides a formal opportunity for comment by industry groups. However, the exchanges have assured the Commission that it is their practice to seek out such views when designing their contracts. Moreover, the

Prior to the 1974 amendments to the Act, the statutory scheme did not require the Commodity Exchange Authority, the Commission's predecessor agency, to approve in advance the trading of all new futures contracts,[30] nor did it require agency approval of exchange rules before they became effective. Rather, exchange rules amending the terms and conditions of futures contracts were subject only to disapproval after becoming effective.[31] The prior approval requirements were included in the 1974 amendments to the Act as one of a number of measures to strengthen federal regulatory oversight of the futures industry. These measures included the Commission's authority under section 8a(7) of the Act to alter or amend contract market rules and its section 8a(9) emergency authority.

The exchanges argue forcefully that their ability to counter competition from foreign exchanges requires that the Commission rely less on its prior-approval authority. They argue that the ability to list contracts without Commission approval is central to their ability to meet foreign competition. To date, relatively few contracts traded on foreign exchanges directly compete with contracts traded on U.S. exchanges, and for those that do, few, if any, U.S. contracts have been displaced by a foreign competitor.[32] Nevertheless, the Commission believes

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Commission will continue to provide a forum for industry groups to make their views known to it regarding the terms and conditions of all contracts, including newly listed contracts.

[30] Prior to 1974, the Act defined "commodity" by specific enumeration. Accordingly, new contracts that were not so enumerated were unregulated. The definition of commodity periodically would be updated to include additional commodities in which trading had commenced on those exchanges which traded other regulated contracts. For example, livestock and livestock products were added to the Act's definition of "commodity" as part of the 1968 amendments to the Act, after such contracts had already begun trading on the Chicago Mercantile Exchange. Pub. L. No. 90-258 §1(a), 49 Stat. 1491 (1968). Other futures exchanges, including the Commodity Exchange, Inc. and the former Coffee and Sugar, and the Cocoa exchanges, operated wholly outside of the regulatory scheme.

[31] See, Pub. L. No. 90-258, §23, 82 Stat. 33 (1968)

[32] See, "The Global Competitiveness of U.S. Futures Markets Revisited," Report of the Division of Economic Analysis to the Commodity Futures Trading Commission (October, 1999).

that, consistent with its mandate to protect market integrity, financial integrity, guard against market manipulation and protect customers, it should ensure that the regulatory scheme not unnecessarily impede the exchanges from competing. By this rulemaking, the Commission is exercising its mandate flexibly to accomplish those goals.

The public interest in the integrity and fairness of the futures markets can be achieved through greater reliance by the Commission on its surveillance and enforcement authorities. As the exchanges recognize, the Commission has available to it strong oversight authorities over boards of trade and their contracts without approving an application for contract market designation and the contract's terms. As one exchange noted, "by letting such an exchange list new contracts without Commission approval . . . the CFTC would not have lost oversight authority over the exchange or its contracts." NYBOT comment letter at 2. The CBT observed that, "eliminating the requirement of Commission approval of new contracts would not affect the Commission's general authority over a contract's terms and conditions." CBT comment letter at 3.

For the reasons explained above, the Commission believes that rule 5.3 is consistent with the public interest and would not have a material adverse effect on the ability of the Commission to discharge its regulatory responsibilities or of any contract market to discharge its self-regulatory responsibilities under the Act. Moreover, because the rule applies to contracts listed on exchanges subject to the self-regulatory requirements of the Act, the Commission finds all traders are "appropriate" for application of this exemptive rule under section 4(c) of the Act.

V. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA), 5 U.S.C. 601 *et seq.*, requires that agencies, in promulgating rules, consider the impact of these rules on small entities. The Commission has previously determined that contract markets are not "small entities" for purposes of the RFA, 5 U.S.C. 601 *et seq.* 47 FR 18618 (April 30, 1982). These final amendments permit exchanges under section 4(c) of the Act to list new contracts for trading without designation as a contract market in that contract. Accordingly, the Chairman, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C. 605(b), that the action taken herein will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

Guideline No. 1 (17 CFR Part 5 Appendix A), which sets forth the requirements for applications for contract designation, contains information collection requirements. As required by the PRA of 1995 (Pub. L. 104-13 (May 13, 1996)), the Commission submitted a copy of the proposed rule to the Office of Management and Budget (OMB) for its review (44 U.S.C. 3504(h)) and indicated that there was no implication for the paperwork burden. Based on the comments the Commission received in response to the proposed rulemaking, the Commission is revising the paperwork burden associated with the new rule as reflected below.

OMB previously approved the collection of information related to this rule as information collection 3038-0022, Regulations Pertaining to the Responsibilities of Contract Markets and Their Members. The final rule adopted by the Commission, which has been submitted to OMB for approval, has the following paperwork burden:

Number of respondents:	11.
Estimated average hours per response:	29.
Frequency of response:	On occasion.
Number of responses per year:	11.
Annual reporting burden:	319.

This represents a reduction of 1073 burden hours based on the Commission's estimation of the number of contract market designation applications that would no longer be submitted under regular or fast-track procedures. Persons wishing to comment on the paperwork burden contained in the final rules may contact the Desk Officer, CFTC, Office of Management and Budget, Room 10202, NEOB, Washington, DC 20503, (202) 395-7340. Copies of the information collection submission to OMB are available from the CFTC Clearance Officer, 1155 21st Street, NW, Washington, DC 20581, (202) 418-5160.

List of Subjects in 17 CFR Part 5

Contract markets, designation application.

In consideration of the foregoing, and pursuant to the authority contained in the Commodity Exchange Act and, in particular, sections 4, 4c, 5, 5a, 6 and 8a thereof, 7 U.S.C. 6, 6c, 7, 7a, 8, and 12a, the Commission hereby amends Chapter I of Title 17 of the Code of Federal Regulations as follows:

Part 5 Contract Market Compliance

1. The authority citation for Part 5 is amended by revising it to read as follows:

Authority: 7 U.S.C. 6(c), 6c, 7, 7a, 8 and 12a.

2. Part 5 is amended by adding a new section 5.3 to read as follows:

§5.3 Listing contracts for trading by exchange certification.

(a) Notwithstanding the provisions of section 4(a)(1) of the Act or §33.2 of this chapter, a board of trade may list for trading contracts of sale of a commodity for future delivery or commodity option contracts, if the board of trade:

(i) is designated under sections 4c, 5, 5a(a) and 6 of the Act as a contract market in at least one commodity which is not dormant within the meaning of §5.2 of this part;

(ii) in connection with the trading of the contract complies with all requirements of the Act and Commission regulations thereunder applicable to designated contract markets, except for the requirement under section 5a(a)(12) of the Act and § 1.41(b) of this chapter that the terms and conditions of the contract be approved by the Commission ;

(iii) files with the Commission at its Washington, D.C., headquarters and the regional office having jurisdiction over it a copy of the contract's initial terms and conditions and a certification by the board of trade that the contract's initial terms and conditions neither violate nor are inconsistent with any provision of the Commodity Exchange Act or of the rules thereunder, and the filing is received no later than the close of business of the business day preceding the contract's initial listing;

(iv) files with the Commission at its Washington, D.C., headquarters and the regional office having jurisdiction over it the text of each amendment to the contract terms and conditions (with deletions in brackets and additions underscored), a brief explanation of the amendment including a description of any substantive opposing views by members of the board of trade or others and a certification by the board of trade that the amendment neither violates nor is inconsistent with any provision of the Commodity Exchange Act or of the rules thereunder, and the filing is received no later than the close of business of the business day preceding the amendment's implementation;

(v) implements amendments to the contract terms and conditions only in trading months having no open interest at the time of implementation; and

(vi) identifies the contract in its rules as listed for trading pursuant to exchange certification.

(b) The board of trade must enforce each bylaw, rule, regulation and resolution that relates to the terms or conditions of a contract listed for trading under this section.

(c) Contracts listed for trading pursuant to this section shall not be void or voidable as a result of:

(i) a violation by the board of trade of the provisions of this section; or

(ii) any Commission proceeding to disapprove designation under section 6 of the Act, to disapprove a term or condition under section 5a(a)(12) of the Act, to alter or supplement a term or condition under section 8a(7) of the Act, to amend the contract's terms or conditions under section 5a(a)(10) of the Act, to declare an emergency under section 8a(9) of the Act, or any other proceeding the effect of which is to disapprove, alter, supplement, or require a contract market to adopt a specific term or condition, trading rule or procedure, or to take or refrain from taking a specific action.

(d) Except as specified in paragraph (a) of this section and unless the context otherwise requires, the board of trade listing contracts, and the contracts listed, for trading under this section shall be subject to all of the provisions of the Act and Commission regulations thereunder which are applicable to a "board of trade," "board of trade licensed by the Commission," "exchange," "contract market," "designated contract market," or "contract market

designated by the Commission" as though those provisions were set forth herein and included specific reference to contracts listed for trading pursuant to this section.

(e) The provisions of this section shall not apply to :

(i) a contract subject to the provisions of section 2(a)(1)(B) of the Act;

(ii) a contract to be listed initially for trading that is the same or substantially the same as one for which an application for contract market designation under sections 4c, 5, 5a and 6 of the Act or §5.1 of this part already was filed for Commission approval by another board of trade while the application is pending before the Commission;

(iii) a contract to be listed initially for trading that is the same or substantially the same as one which is the subject of a pending Commission proceeding to disapprove designation under section 6 of the Act, to disapprove a term or condition under section 5a(a)(12) of the Act, to alter or supplement a term or condition under section 8a(7) of the Act, to amend terms or conditions under section 5a(a)(10) of the Act, to declare an emergency under section 8a(9) of the Act, or to any other proceeding the effect of which is to disapprove, alter, supplement, or require a contract market to adopt a specific term or condition, trading rule or procedure, or to take or refrain from taking a specific action.

Issued in Washington, D.C., this 17th day of November, 1999, by the Commodity Futures Trading Commission.

Jean A. Webb
Secretary of the Commission