been initiated, any significant price discovery contract that has no open interest and in which no trading has occurred for a period of 12 complete and consecutive calendar months shall, without further proceedings, no longer be considered to be a significant price discovery contract.

(d) Commission Review. The Commission shall, at least annually, evaluate as appropriate agreements, contracts or transactions conducted on an electronic trading facility in reliance on the exemption provided in section 2(h)(3) of the Act to determine whether they serve a significant price discovery function as described in § (d)(1) above.


APPENDIX A TO PART 36—GUIDANCE ON SIGNIFICANT PRICE DISCOVERY CONTRACTS

1. Section 2(h)(7) of the CEA specifies four factors that the Commission must consider, as appropriate, in making a determination that a contract is performing a significant price discovery function. The four factors prescribed by the statute are: Price Linkage; Arbitrage; Material Price Reference; and Material Liquidity.

2. Not all listed factors must be present to support a determination that a contract performs a significant price discovery function. Moreover, the statutory language neither prioritizes the factors nor specifies the degree to which a significant price discovery contract must conform to the various factors. Congress has indicated that it intends that the Commission should not make a determination that an agreement, contract or transaction performs a significant price discovery function on the basis of the Price Linkage factor unless the agreement, contract or transaction also has sufficient volume to impact other regulated contracts or to become an independent price reference or benchmark that is regularly utilized by the public. The Commission believes that the Arbitrage and Material Price Reference factors can be considered separately from each other. That is, the Commission could make a determination that a contract serves a significant price discovery function based on the presence of one of these factors and the absence of the other. The presence of any of these factors, however, would not necessarily be sufficient to establish the contract as a significant price discovery contract. The fourth factor, Liquidity, would be considered in conjunction with the arbitrage and linkage factors as a significant amount of liquidity presumably would be necessary for a contract to perform a significant price discovery function in conjunction with these factors.

3. These factors do not lend themselves to a mechanical checklist or formulaic analysis. Accordingly, this guidance is intended to illustrate which factors, or combinations of factors, the Commission will look to when determining that a contract is performing a significant price discovery function, and under what circumstances the presence of a particular factor or factors would be sufficient to support such a determination.

(A) MATERIAL LIQUIDITY—The extent to which the volume of agreements, contracts or transactions in the commodity being traded on the electronic trading facility is sufficient to have a material effect on other agreements, contracts or transactions listed for trading on or subject to the rules of a designated contract market, a derivatives transaction execution facility, or an electronic trading facility operating in reliance on the exemption in section 2(h)(3) of the Act.

1. Liquidity is a broad concept that captures the ability to transact immediately with little or no price concession. Traditionally, objective measures of trading such as volume or open interest have been used as measures of liquidity. So, for example, a market in which trades occur multiple times per minute at prices that differ by only fractions of a cent normally would be considered highly liquid, since presumably a trader could quickly execute a trade at a price that was approximately the same as the price for other recently executed trades. Other factors also will affect the characterization of liquidity, such as whether a large trade—e.g., 100 contracts versus 1 contract—could be executed without a significant price concession. For example, having to wait a day to sell 1,000 bushels of corn may be considered an illiquid market while waiting a day to sell a home may be considered quite liquid. Thus, quantifying the levels of immediacy and price concession that would define material liquidity may differ from one market or commodity to another.

2. The Commission believes that material liquidity alternatively can be identified by the impact liquidity exhibits through observed prices. In markets where material liquidity exists, a more or less continuous stream of prices can be observed and the prices should be similar. For example, if the trading of a contract occurs on average five times a day, there will be on average five observed prices for the contract per day. If the market is liquid in terms of traders having to make little in the way of price concessions to execute these trades, the prices of this contract should be similar to those observed for similar or related contracts traded
in liquid markets elsewhere. Thus, in making determinations that contracts have material liquidity, the Commission will look to transaction prices, both in terms of how often prices are observed and the extent to which observed prices tend to correlate with other contemporaneous prices.

3. The Commission anticipates that material liquidity will frequently be a consideration in evaluating whether a contract is a significant price discovery contract; however, there may be circumstances in which other factors so dominate the conclusion that a contract is serving a significant price discovery function that a finding of material liquidity in the contract would not be necessary. Circumstances in which this might arise are discussed with respect to the assessment of other factors below.

4. Finally, material liquidity itself would not be sufficient to make a determination that a contract is a significant price discovery contract, but combined with other factors it can serve as a guidepost indicating which contracts are functioning as significant price discovery contracts. As further discussed below, material liquidity, as reflected through the prices of linked or arbitrated contracts, will be a primary consideration in determining whether such contracts are significant price discovery contracts.

(B) PRICE LINKAGE—The extent to which the agreement, contract or transaction uses or otherwise relies on a daily or final settlement price, or other major price parameter, of a contract or contracts listed for trading on or subject to the rules of a designated contract market or a derivatives transaction execution facility, or a significant price discovery contract traded on an electronic trading facility, to value a position, transfer or convert a position, cash or financially settle a position, or close out a position.

1. A price-linked contract is a contract that relies on a contract traded on another trading facility to settle, value or otherwise offset the price-linked contract. The link may involve a one-to-one linkage, in that the value of the linked contract is based on a single contract’s price, or it may involve multiple contracts. An example of a multiple contract linkage might be where the settlement price is calculated as an index of prices obtained from a basket of contracts traded on other exchanges.

2. For a linked contract, the mere fact that a contract is linked to another contract will not be sufficient to support a determination that a contract performs a significant price discovery function. To assess whether such a determination is warranted, the Commission will examine the relationship between transaction prices of the linked contract and the prices of the referenced contract(s). The Commission believes that where material liquidity exists, prices for the linked contract would be observed to be substantially the same as or move substantially in conjunction with the prices of the referenced contract(s). Where such price characteristics are observed on an ongoing basis, the Commission would expect to determine that the linked contract is a significant price discovery contract.

3. As an example, where the Commission has observed price linkage, it will next consider whether transactions were occurring on a daily basis for the linked contract in material volumes. (Conversely, where volume has increased noticeably in a particular contract, the Commission would look for linkage) The ultimate level of volume that would be considered material for purposes of determining a contract a significant price discovery contract will likely differ from one contract to another depending on the characteristics of the underlying commodity and the overall size of the physical market in which it is traded. At a minimum, however, the Commission will consider a linked contract which has volume equal to 5% of the volume of trading in the contract to which it is linked to have sufficient volume potentially to be deemed a significant price discovery contract.

4. In combination with this volume level, the Commission will also examine the relationship between prices of the linked contract and the contract to which it is linked to determine whether a contract is serving a significant price discovery function. As a threshold, the Commission will consider a 2.5 percent price range for 95 percent of contemporaneously determined closing, settlement, or other daily prices over the most recent quarter to be sufficiently close for a linked contract potentially to be deemed a significant price discovery contract. For example, if, over the most recent quarter, it was found that 95 percent of the closing, settlement, or other daily prices of the contract, which have been calculated using transaction prices, were within 2.5 percent of the contemporaneously determined closing, settlement, or other daily prices of a contract to which it was linked, the Commission potentially would consider the contract to perform a significant price discovery function.

(C) ARBITRAGE CONTRACTS—The extent to which the price for the agreement, contract or transaction is sufficiently related to the price of a contract or contracts listed for trading on or subject to the rules of a designated contract market or derivatives transaction execution facility, or a significant price discovery contract or contracts trading on or subject to the rules of an electronic trading facility, so as to permit market participants to effectively arbitrage between the markets by simultaneously maintaining positions or executing trades in the contracts on a frequent and recurring basis.

1. Arbitrage contracts are those contracts that can be combined with other contracts to exploit expected economic relationships.
in anticipation of a profit. In assessing whether a contract can be incorporated into an arbitrage strategy, the Commission will weigh the terms and conditions of a contract in comparison to contracts that potentially could be used in an arbitrage strategy; will consult with industry or other sources regarding a contract’s viability in an arbitrage strategy; and will examine the relationship between transaction prices of an arbitrage contract and the prices of the contract(s) to which it is related. The Commission believes that where material liquidity exists, prices for the arbitrage contract would be observed to move substantially in conjunction with the prices of the related contract(s) to which it is economically linked. Where such price characteristics are observed on an ongoing basis, it is likely that the linked contract performs a significant price discovery function.

3. The Commission will apply the same threshold liquidity and price relationship standards for arbitrage contracts as it does for linked contracts. That is, the Commission will view the average of five trades per day or more threshold as the level of activity that would potentially meet the material volume criterion. With respect to prices, the Commission will consider an arbitrage contract potentially to be a significant price discovery contract if, over the most recent quarter, greater than 95 percent of the closing or settlement prices of the contract, which have been calculated using transaction prices, fall within 2.5 percent of the closing or settlement price of the contract or contracts to which it could be arbitrated.

D. MATERIAL PRICE REFERENCE—The extent to which, on a frequent and recurring basis, bids, offers or transactions in a commodity are directly based on, or determined by referencing, the prices generated by agreements, contracts or transactions being traded or executed on the electronic trading facility.

1. The Commission will rely on one of two sources of evidence—direct or indirect—to determine that the price of a contract was being used as a material price reference and, therefore, serving a significant price discovery function. The primary source of direct evidence is that cash market bids, offers or transactions are directly based on, or quoted at a differential to, the prices generated on the market on a frequent and recurring basis. The Commission expects that normally only contracts with material liquidity will be referenced by the cash market; however, the Commission notes that it may be possible for a contract to have very low liquidity and yet still be used as a price reference. In such cases, the simple fact that participants in the underlying cash market broadly have elected to use the contract price as a price reference or confirming the use of a contract in arbitrage strategies.

2. As with linked contracts, the mere fact that a contract could be employed in an arbitrage strategy will not be sufficient to make a determination that a contract is a significant price discovery contract. In addition, the level of liquidity will be considered. To assess whether designation as a significant price discovery contract is warranted, the Commission will examine the relationship between transaction prices of an arbitrage contract and the prices of the contract(s) to which it is related. The Commission believes that where material liquidity exists, prices for the arbitrage contract would be observed to move substantially in conjunction with the prices of the related contract(s) to which it is economically linked. Where such price characteristics are observed on an ongoing basis, it is likely that the linked contract performs a significant price discovery function.

3. The second source of evidence is that the price of a contract is being routinely disseminated in widely distributed industry publications—or offered by the ECM itself for some form of remuneration—and considered on a frequent and recurring basis by industry participants in pricing cash market transactions. As with contract prices that are directly incorporated into cash market prices, the Commission assumes that industry publications choose to publish prices because of the value they transfer to industry participants for the purpose of formulating prices in the cash market.

4. In applying this criterion, consideration will be given to whether prices established by a section 2(h)(3) contract are reported in a widely distributed industry publication. In making this determination, the Commission will consider the reputation of the publication within the industry, how frequently it is published, and whether the information contained in the publication is routinely consulted by industry participants in pricing cash market transactions.

5. Under a Material Price Reference analysis, the Commission expects that material liquidity in the contract likely will be the primary motivation for a publisher to publish particular prices. In other words, the fact that the price of a contract is being used as a reference by industry participants suggests, prima facie, that the contract performs a significant price discovery function. But
the Commission recognizes that trading levels could nonetheless be low for the contract while still serving a significant price discovery function and that evidence of routine publication and consultation by industry participants may be sufficient to establish the contract as a significant price discovery contract. On the other hand, while cash market participants may regularly refer to published prices of a particular contract when establishing cash market prices, it may be the case that the contract itself is a niche market for all grades of the commodity or for delivery at a minor geographic location. In such cases, the Commission will look to such measures as trading volume, open interest, and the significance of the underlying cash market to make a determination that a contract is functioning as a significant price discovery contract. If an examination of trading in that contract were to reveal that true price discovery was occurring in other more broadly defined contracts and that this contract was itself simply reflective of those broader contracts, it is less likely the Commission will deem the contract a significant price discovery contract.

6. Because price referencing normally occurs out of the view of the electronic trading facility, the Commission may have difficulty ascertaining the extent to which cash market participants actually reference or consult a contract’s price when transacting. The Commission expects, however, that as a contract begins to be relied upon to set a reference price, market participants will be increasingly willing to purchase price information. To the extent, then, that an electronic trading facility begins to sell its price information to market participants or industry publications, the contract will meet a threshold standard to indicate that the contract potentially is a significant price discovery contract.

[74 FR 12197, Mar. 23, 2009]

APPENDIX B TO PART 36—GUIDANCE ON, AND ACCEPTABLE PRACTICES IN, COMPLIANCE WITH CORE PRINCIPLES

1. This Appendix provides guidance on complying with the core principles under section 2(h)(7)(C) of the Act and this part, both initially and on an ongoing basis. The guidance is provided in paragraph (a) following each core principle and can be used to demonstrate to the Commission core principle compliance under §36.3(c)(4). The guidance for each core principle is illustrative of the types of measures an electronic trading facility may address, as applicable, and is not intended to be used as a mandatory checklist. Addressing the issues and questions set forth in this guidance will help the Commission in its consideration of whether the electronic trading facility is in compliance with the core principles. A submission pursuant to §36.3(c)(4) should include an explanation or other form of documentation demonstrating that the electronic trading facility complies with the core principles.

2. Acceptable practices meeting selected requirements of the core principles are set forth in paragraph (b) following each core principle. Electronic trading facilities on which significant price discovery contracts are traded or executed that follow the specific practices outlined under paragraph (b) for any core principle in this appendix will meet the selected requirements of the applicable core principle. Paragraph (b) is for illustrative purposes only, and does not state the exclusive means for satisfying a core principle.

CORE PRINCIPLE I OF SECTION 2(h)(7)(C)—CONTRACTS NOT READILY SUSCEPTIBLE TO MANIPULATION. The electronic trading facility shall list only significant price discovery contracts that are not readily susceptible to manipulation.

(a) Guidance. Upon determination by the Commission that a contract listed for trading on an electronic trading facility is a significant price discovery contract, the electronic trading facility must self-certify the terms and conditions of the significant price discovery contract under §36.3(c)(4) within 90 calendar days of the date of the Commission’s order, if the contract is the electronic trading facility’s first significant price discovery contract; or 30 days from the date of the Commission’s order if the contract is not the electronic trading facility’s first significant price discovery contract. Once the Commission determines that a contract performs a significant price discovery function, subsequent rule changes must be self-certified to the Commission by the electronic trading facility pursuant to §40.6 or submitted to the Commission for review and approval pursuant to §40.5.

(b) Acceptable practices. Guideline No. 1, 17 CFR part 40, Appendix A may be used as guidance in meeting this core principle for significant price discovery contracts.

CORE PRINCIPLE II OF SECTION 2(h)(7)(C)—MONITORING OF TRADING. The electronic trading facility shall monitor trading in significant price discovery contracts to prevent market manipulation, price distortion, and disruptions of the delivery of cash-settlement process through market surveillance, compliance and disciplinary practices and procedures, including methods for conducting real-time monitoring of trading and comprehensive and accurate trade reconstructions.

(a) Guidance. An electronic trading facility on which significant price discovery contracts are traded or executed should, with respect to those contracts, demonstrate a capacity to prevent market manipulation and