(1) If no additional crack propagation is detected during any of the repetitive inspections: Within 6 months after discovery of the crack, either repair the rib boom angle or replace the rib boom angle assembly in accordance with paragraph (b) of this AD.

(2) If any of the repetitive inspections reveal that crack propagation has reached or extends beyond bolt hole Y or into bolt hole A: Prior to further flight, either repair the rib boom angle or replace the rib boom assembly in accordance with paragraph (b) of this AD.

(e) If any crack is detected on only one rib boom angle, and that crack extends beyond bolt hole X, but not beyond bolt hole Y or down towards bolt hole A: Repeat the detailed visual inspection of the rib boom angle for additional crack propagation at intervals not to exceed 100 hours time-in-service.

(1) If no additional crack propagation is detected during any of the repetitive inspections: Within 3 months after discovery of the crack, either repair the rib boom angle or replace the rib boom angle assembly in accordance with paragraph (b) of this AD.

(2) If any of the repetitive inspections reveal that crack propagation has reached or extends beyond bolt hole Y or into bolt hole A: Prior to further flight, either repair the rib boom angle or replace the rib boom angle assembly in accordance with paragraph (b) of this AD.

(f) If any crack is detected on only one rib boom angle, and that crack extends beyond bolt hole Y or into bolt hole A: Prior to further flight, either repair the rib boom angle or replace the rib boom angle assembly in accordance with paragraph (b) of this AD.

(g) If any crack is detected on both rib boom angles, and cracks do not extend beyond bolt hole X: Repeat the detailed visual inspection of the rib boom angles for additional crack propagation at intervals not to exceed 100 hours time-in-service.

(1) If no additional crack propagation is detected during any of the repetitive inspections: Within 3 months after discovery of the cracks, either repair the rib boom angles or replace the rib boom angle assembly in accordance with paragraph (b) of this AD.

(2) If any of the repetitive inspections reveal that crack propagation has reached or extends beyond bolt hole Y or into bolt hole A: Prior to further flight, either repair the rib boom angles or replace the rib boom angle assembly in accordance with paragraph (b) of this AD.

(h) If any crack is detected on both rib boom angles, and cracks extend beyond bolt hole X, but not beyond bolt hole Y or down towards bolt hole A: Repeat the detailed visual inspection of the rib boom angles for additional crack propagation at intervals not to exceed 50 hours time-in-service.

(1) If no additional crack propagation is detected during any of the repetitive inspections: Within 1 month after discovery of the cracks, either repair the rib boom angles or replace the rib boom angle assembly in accordance with paragraph (b) of this AD.

(2) If any of the repetitive inspections reveal that crack propagation has reached or extends beyond bolt hole Y or into bolt hole A: Prior to further flight, either repair the rib boom angles or replace the rib boom angle assembly in accordance with paragraph (b) of this AD.

(i) If any crack is detected on both rib boom angles, and cracks extend beyond bolt hole Y or into bolt hole A: Prior to further flight, either repair the rib boom angles or replace the rib boom angle assembly in accordance with paragraph (b) of this AD

(j) An alternative method of compliance or adjustment of the compliance time that provides an acceptable level of safety may be used if approved by the Manager, Standardization Branch, ANM–113, FAA, Transport Airplane Directorate. Operators shall submit their requests through an appropriate FAA Principal Maintenance Inspector, who may add comments and then send it to the Manager, Standardization Branch, ANM–113.

Note 2: Information concerning the existence of approved alternative methods of compliance with this AD, if any, may be obtained from the Standardization Branch, ANM–113.

Note 3: Alternative methods of compliance previously granted for amendment 39–8632, AD 93–14–08, continue to be considered as acceptable alternative methods of compliance with this amendment.

(k) Special flight permits may be issued in accordance with sections 21.197 and 21.199 of the Federal Aviation Regulations (14 CFR 21.197 and 21.199) to operate the airplane to a location where the requirements of this AD can be accomplished.

(l) The inspections shall be done in accordance with Jetstream Service Bulletin ATP–57–13, Revision 5, dated June 3, 1994. Revision 5 of Jetstream Service Bulletin ATP–57–13 contains the following list of effective pages:

Page No.	Revision level shown on page	Date shown on page
1–3, 5	5	June 3, 1994.
4, 6	4	May 31, 1994.
7–12	3	Mar. 23, 1994.

The replacement shall be done in accordance with British Aerospace Service Bulletin ATP–57–13, Revision 1, dated January 15, 1993, or Jetstream Service Bulletin ATP–57–16–10313A, Revision 1, dated July 2, 1994 (as corrected by Erratum 2, dated August 30, 1994). The incorporation by reference of British Aerospace Service Bulletin ATP–57–13, Revision 1, dated January 15, 1993, was approved previously by the Director of the Federal Register in accordance with 5 U.S.C. 552(a) and 1 CFR part 51 as of September 8, 1993 (58 FR 42194, August 9, 1993). The incorporation by reference of the remainder of the service documents listed above is approved by the Director of the Federal Register in accordance with 5 U.S.C. 552(a) and 1 CFR part 51. Copies may be obtained from Jetstream Aircraft, Inc., P.O. Box 16029, Dulles International Airport, Washington, DC 20041–6029. Copies may be inspected at the FAA, Transport Airplane Directorate, 1601 Lind Avenue, SW., Renton, Washington; or at the Office of the Federal Register, 800 North Capitol Street, NW., suite 700, Washington, DC.

(m) This amendment becomes effective on November 1, 1995.

Issued in Renton, Washington, on September 6, 1995.

Darrell M. Pederson,

Acting Manager, Transport Airplane Directorate, Aircraft Certification Service.

[FR Doc. 95–22589 Filed 9–29–95; 8:45 am]

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COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 36

Section 4(c) Contract Market Transactions

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rules.

SUMMARY: Pursuant to section 4(c) of the Commodity Exchange Act, the Commission is promulgating final rules to exempt certain contract market transactions from specified requirements of the Commodity Exchange Act, 7 U.S.C. 1 *et seq.* (''CEA'' or ''Act''), and Commission regulations thereunder. The Commission proposed these rules after considering the public comments on petitions for exemptive relief submitted by the Chicago Mercantile Exchange (''CME'') and by the Board of Trade of the City of Chicago (''CBT'').

Based upon its consideration of the comments received in response to its Notice of Proposed Rulemaking, and upon its independent analysis, the Commission is promulgating final rules establishing a three-year pilot program to permit certain transactions to trade on section 4(c) contract markets exempt from specified requirements of the Act and Commission rules. The Commission believes that permitting, on a pilot basis, the trading of this new class of contract market transaction, which can be offered only to specified categories of individuals or entities, is in the public interest.

The final rules will permit these exchange-traded products greater flexibility in competing with foreign exchange-traded products and with both foreign and domestic over-the-counter transactions, while maintaining basic customer protection, financial integrity and other protections associated with trading in an exchange environment. In particular, new Part 36 permits greater flexibility with respect to trading rules (section 36.3); listing of transactions (section 36.4); reporting requirements

(section 36.5); registration requirements (section 36.36) and risk disclosure (section 36.7). It also reserves the anti-manipulation prohibitions in the Act and Commission Rule 33.9 and provides for anti-fraud prohibitions in addition to those otherwise applicable to section 4(c) contract market transactions under the Act and Commission Rule 33.10.

Finally, although the Commission requested comment relating to the advisability of making certain conforming changes to its Part 35 Exemption of Swap Agreements, the Commission has determined to make no changes herein to Part 35.

EFFECTIVE DATE: November 1, 1995.

FOR FURTHER INFORMATION CONTACT: Paul M. Architzel, Chief Counsel, Division of Economic Analysis; Alan L. Seifert, Deputy Director, or Lawrence B. Patent, Associate Chief Counsel, Division of Trading and Markets; or Ellyn S. Roth, Attorney, Office of the General Counsel; Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, D.C. 20581, (202) 418–5260, 418–5450, and 418–5120, respectively.

SUPPLEMENTARY INFORMATION:

I. Statutory Background

The Futures Trading Practices Act of 1992, P.L. No. 102–546 (October 28, 1992) (''1992 Act''), added new subsections (c) and (d) to section 4 of the Act. These new provisions authorize the Commission, by rule, regulation, or order, to exempt any agreement, contract or transaction, or class thereof, when entered into between ''appropriate persons'' from the exchange-trading, or any other, requirement of the Act other than section 2(a)(1)(B), 7 U.S.C. 2.[1] Before granting such an exemption, the Commission must determine that its action 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.[2]

II. The Petitions for Exemptive Relief

On August 16, 1993, the Commission published in the Federal Register notice of, and a request for comment on, petitions for exemption under section 4(c) of the Act submitted by the CME and the CBT.[3] As detailed in that Federal Register notice, the CME sought an exemption from most of the provisions of the Act and Commission regulations with regard to the purchase and sale of its Rolling Spot™ futures and options contracts. The CBT's petition, submitted on June 30, 1993 (''section 4(c) petition''), and subsequently joined by the New York Mercantile Exchange (''NYMEX''),[4] requested that the Commission establish a ''professional trading market exemption'' from most of the provisions of the Act and regulations for trading in any instrument of the CBT and other boards of trade, including those designated previously as contract markets by the Commission. Under both petitions, trading in exempted instruments would have been limited to certain participants, and trades would have been cleared through an exchange clearing system approved by the Commission.

The substance of the comments on the petitions is discussed in the Notice of Proposed Rulemaking, 59 FR 54139 at 54140–54141 (Oct. 28, 1994). The CBT, as part of its comments responding to the Notice of Proposed Rulemaking, offered several amendments to its section 4(c) petition. Of these, the most notable would limit the transactions eligible for exemptive relief to ''swap agreements'' as defined by Commission Rule 35.1(b).[5]

III. The Proposed Rules

In light of the comments received on the exchange petitions, and based on its own analysis, the Commission proposed a new Part 36 of its rules.[6] The proposed rules would establish a pilot program to provide more streamlined procedures for listing new exchange-traded products and greater flexibility in the trading procedures for those products, the offer and sale of which would be limited to specified categories of individuals or entities. In addition, the proposed rules would provide greater flexibility to qualified market users in certain areas, particularly relating to registration and account opening procedures.

A. Duration and Scope of Exemption

The Commission proposed to implement these rules under the framework of a three-year pilot program, providing the exchanges and the Commission an opportunity to test whether actual trading under the proposed rules, in fact, was, and remained, in the public interest, and to determine the effect of such trading on the integrity of the marketplace as a whole. The Commission specifically requested comment on the concept and feasibility of such a pilot program. Given the pilot nature of this program, the Commission also proposed that the exemption could be revoked at any time, following notice and an opportunity for hearing, upon a determination that the continued operation of the exemption was no longer consistent with the public interest.

With regard to the scope of the exemption, proposed section 36.1(b) provided that boards of trade listing section 4(c) contract market transactions for trading would be deemed to be ''contract markets'' which must comply with all provisions of the Act and

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[1] Section 2(a)(1)(A) of the Act grants the Commission exclusive jurisdiction over ''accounts, agreements (including any transaction which is of the character of * * * an 'option' * * *), and transactions involving contracts of sale of a commodity for future delivery traded or executed on a contract market * * * or any other board of trade, exchange, or market. * * *'' 7 U.S.C. 2. The CEA and Commission regulations require that transactions in commodity futures contracts and commodity option contracts, with narrowly defined exceptions, occur on or subject to the rules of contract markets designated by the Commission.

Specifically, Section 4(c)(1), 7 U.S.C. 6(c)(1), provides:

In order to promote responsible economic or financial innovation and fair competition, the Commission by rule, regulation, or order, after notice and opportunity for hearing, may (on its own initiative or on application of any person, including any board of trade designated as a contract market for transactions for future delivery in any commodity under section 5 of this Act) exempt any agreement, contract, or transaction (or class thereof) that is otherwise subject to subsection (a) (including any person or class of persons offering, entering into, rendering advice or rendering other services with respect to, the agreement, contract, or transaction), either unconditionally or on stated terms or conditions or for stated periods and either retroactively or prospectively, or both, from any of the requirements of subsection (a), or from any other provision of this Act (except Section 2(a)(1)(B)), if the Commission determines that the exemption would be consistent with the public interest.

[2] Specifically, Section 4(c)(2), 7 U.S.C. 6(c)(2), states:

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.

[3] 58 FR 43414 (Aug. 16, 1993); 58 FR 44402 (Aug. 20, 1993) (correction); 58 FR 52948 (Oct. 13, 1993) (extension of comment period to Dec. 15, 1993).

[4] By letter dated September 20, 1994, subsequent to the close of the comment period, the NYMEX joined in the CBT's petition.

[5] *See* Comment letter of the Board of Trade of the City of Chicago, dated December 13, 1994.

[6] 59 FR 54139 (Oct. 28, 1994); 59 FR 64359 (Dec. 14, 1994) (extension of comment period to January 31, 1995).

Commission regulations, except for those provisions which are ''specifically inconsistent'' with the proposed rules. Transactions in these instruments were proposed to be limited to ''eligible participants,'' the definition of which was based upon the list of ''appropriate persons'' set forth in section 4(c)(3) (A) through (J) of the Act, with certain revisions tailored to this particular market and reflecting the Commission's experience in applying similar concepts in the context of other exemptions. In this regard, the Commission asked commenters to address the issue of whether certain of the proposed revisions should be applied to the Commission's previously-granted exemption under Part 35,[7]as well.

Proposed section 36.2 limited the potential breadth of the exemption, specifying that section 4(c) contract market transactions must be: (1) cash-settled, or that delivery be by ''means other than the transfer or receipt of any commodity, except a major foreign currency;'' (2) cleared through a clearing organization subject to Commission oversight; and, (3) based on commodities other than the agricultural commodities enumerated in section 1a of the Act, except for a broad-based index thereof. Proposed section 36.2(a)(4) further would have limited section 4(c) contract market transactions to those transactions which could ''reasonably be distinguished'' based upon the contract's hedging function or pricing function from futures or option contracts already designated by the Commission at the time of application to trade a section 4(c) contract market transaction.[8] Finally, any transaction subject to section 2(a)(1)(B) of the Act, 7 U.S.C. 2, including stock index futures contracts, was proposed to be excluded from the scope of the exemptive rules.

B. Trading Rules and Procedures

Section 36.3 proposed to permit section 4(c) contract markets greater flexibility in trading procedures and systems and to establish a streamlined procedure for Commission review of the contract market rules implementing those procedures. As proposed, section 36.3 would have permitted significant flexibility for trading procedures and systems. In particular, by permitting upstairs or other forms of off-floor execution if certain broad criteria were met, the proposed rule departed profoundly from current regulatory constraints. The limiting criteria included: meeting certain Commission recordkeeping and audit trail requirements; maintaining customer protection standards under Commission Rules 155.2, 155.3, and 155.4, to the extent applicable; providing for post-trade transparency of the transactions, including specified reporting requirements identifying section 4(c) contract market transactions from non-section 4(c) contract market transactions; and clearing such transactions on the same schedule as products traded on non-section 4(c) contract markets. Further, any submission made under the proposed rule would have been required to describe fully the contract market procedures and systems to assure compliance with sections 4b and 4c(a) of the Act, which prohibit the abuse of customer orders. Such abuses include frontrunning customer orders, misuse of information, wash sales and fictitious trades. Procedurally, the Commission proposed that such trading rules be submitted for its review prior to being put into effect. Absent notification to the contrary, these rules would become effective ten days after receipt.

C. Listing Procedures

The Commission proposed that section 4(c) contract market transactions be listed for trading ten days after submission to the Commission of their terms and conditions, unless the Commission notified the board of trade in writing during that period that the transactions did not meet the conditions specified by the rules. In that event, the terms and conditions of the transaction would be subject to the usual rule approval procedures under section 5a(a)(12)(A) of the Act.

D. Reporting Requirements

The Commission proposed that, in lieu of its current reporting requirements under Parts 16–19 of its rules, section 4(c) contract markets, futures commission merchants (''FCMs''), and large traders comply with reporting requirements specifically geared toward these markets. Most notably, in addition to publishing daily information on total open interest, transactions, and prices for each commodity or type of contract, the Commission proposed that section 4(c) contract markets provide open interest and transaction information for each clearing member similar to that required under current Rule 16.00. However, although required to be maintained in a manner that is readily accessible, contract markets would be required to supply information concerning large traders conducting section 4(c) contract market transactions only on call by the Commission. The actual frequency of those reports would be determined based upon market developments.

E. Special Temporary License, Registration or Principal Listing Procedures; Risk Disclosure Requirements

The Commission also proposed, in section 36.6, to allow special registration procedures for persons associated with an FCM or introducing broker (''IB'') whose activities were limited to instruments specified by the Commission in an Appendix to Part 36. These special procedures would be established upon the petition of a contract market and under approved procedures of the National Futures Association (''NFA''). The Commission noted in the Notice of Proposed Rulemaking that particular areas of flexibility in the registration process might include the waiver of NFA's fingerprint requirement and acceptance of alternative proficiency tests. With regard to risk disclosure, the Commission proposed, when accounts for section 4(c) contract market transactions were opened, allowing the use of disclosure statements appropriate to a customer's expertise and financial capacity and tailored to a particular product. This disclosure requirement would have replaced the basic risk disclosure statements generally required when opening accounts. *See, e.g.,* Commission Rules 1.55, 1.65, 33.7, and 190.10.

[7] Part 35 of the Commission's rules exempts swap agreements, as defined in Section 35.1(b), from,

all provisions of the Act (except * * * Sections 2(a)(1)(B), 4b, and 4o of the Act and § 32.9 of this chapter * * *, and the provisions of Sections 6(c) and 9(a)(2) of the Act to the extent these provisions prohibit manipulation of the market price of any commodity in interstate commerce or for future delivery on or subject to the rules of any contract market), provided the following terms and conditions are met:

(a) the swap agreement is entered into solely between eligible swap participants * * *;

(b) the swap agreement is not part of a fungible class of agreements that are standardized * * *;

(c) the creditworthiness of any party having an actual or potential obligation under the swap agreement would be a material consideration * * *; and

(d) the swap agreement is not entered into and traded on or through a multilateral transaction execution facility.

[8] As proposed, Section 36.2(a)(4) specifically identified the following as eligible Section 4(c) contract market transactions: flexible commodity options (which trade under contract market option rules, but are not separately designated); contracts in foreign currency known as Rolling Spot™ Contracts; five- and ten-year interest rate swaps contracts; and foreign currency forward futures contracts and options thereon.

F. Fraud and Manipulation in Connection With Section 4(c) Contract Market Transactions

Finally, the Commission proposed that section 4(c) contract market transactions be subject to the anti-fraud proscriptions of sections 4b(a) and 4*o* of the Act, those provisions of sections 6(c), 6(d), and 9(a) of the Act that prohibit price manipulation, and Commission Rules 33.9 and 33.10, which prohibit fraudulent conduct and price manipulation in connection with commodity option transactions. The Commission also proposed to include in Part 36 a free-standing anti-fraud rule modeled after Commission Rule 33.10, the anti-fraud rule applicable to exchange-traded commodity options, and requested comment on the need for a free-standing anti-manipulation rule. In this regard, the Commission specifically requested comment on whether such stand-alone anti-fraud and anti-manipulation rules were appropriate and whether the swaps exemption also should be amended to include similar rules.

IV. Comments Received

The Commission received 34 comment letters from 29 different commenters[9] in response to its Notice of Proposed Rulemaking. The commenters included: four futures exchanges; two clearing organizations; a securities exchange; seven trade associations; four federal regulatory agencies; a Commission Administrative Law Judge; three bar association committees; two industry lawyers; three investment firms; and two other futures professionals.

The comments carefully analyzed the proposed rules and many responded to the specific questions raised by the Commission. The vast majority of the commenters favored the general concept of the proposed rules, although many recommended clarifications, revisions or modifications to particular provisions. Several industry associations, a state bar association subcommittee, and others, in supporting the proposal, opined that introducing these changes through the framework of a pilot program would be a prudent step toward accommodating and meeting changes that are occurring in the traditional markets.

In this regard, one commenter noted that this proposal is consistent with the Commission's sustained efforts to enhance the competitiveness of the U.S. futures markets. A second commenter noted favorably that the proposal recognizes that certain sophisticated market participants, although enjoying the benefits and enhanced safety of exchange trading, do not necessarily require the full panoply of protections and regulatory provisions.

Significantly, the NYMEX, a futures exchange which joined in the original CBT section 4(c) petition, stated its belief that the structure of the program set forth by the Commission generally strikes the correct balance for establishing an exempt exchange-style market. In its view,

> [s]everal of the areas from which the Commission declined to grant exemptive relief are areas that * * * require regulation in the context of an exchange-traded marketplace, where participants are brought together in a blind-match system and the clearinghouse provides the ultimate source of credit and financial backing.

Other commenters, including, in particular, the other futures exchanges which commented on the proposal, were of the opinion that the Commission did not go far enough in extending relief under the proposed rules, particularly in light of the restrictions on market access. The CME commented, in particular, that the proposed scope of the exemption was too narrow to allow U.S. futures exchanges to compete effectively against over-the-counter (''OTC'') markets and foreign futures exchanges.

One commenter, a commodity trading advisor (''CTA''), urged the Commission to consider expanding the proposed relief to reduce any unwarranted regulatory costs that might be imposed on an exchange-style swaps trading and clearing facility. A futures industry trade association noted that the proposed Part 36 rules would provide relief predominately in the relatively narrow context of trading practices, and recommended that the Commission consider implementing broader exemptive relief for institutional users of the futures markets.

Finally, certain government regulators commenting on the proposed rules, although generally urging caution, recognized that a pilot program was an appropriate framework for proceeding. In particular, the Board of Governors of the Federal Reserve System (''Federal Reserve Board'' or ''Board'') noted that it supported the Commission's use of its authority to grant exemptions to classes of products and market participants for which many of the Act's requirements are unnecessary or burdensome. The Board further stated, however, that exemptions of the breadth contemplated by the exchange petitions could have unintended effects on market integrity, and urged the Commission to take a cautious approach in applying its exemptive authority to exchange-traded instruments.

The Securities and Exchange Commission (''SEC'') also urged caution, stating that although the SEC would not support every element of proposed Part 36, a pilot program would offer the Commission an opportunity to evaluate the entire Part 36 approach in a controlled environment. The United States Department of Labor (''Department of Labor'') stressed that, although the Department of Labor believed that the exemption, as proposed, raises several issues regarding ERISA plan investment in the exempted transactions, by purchasing contracts covered by this exemption rather than over-the-counter (OTC) contracts, plan fiduciaries may secure additional protection for plan assets. The Pilot program would offer several of the advantages of OTC transactions, while operating in an exchange-type environment with its clearinghouse function, transparent pricing, reporting requirements, daily settlement, heightened liquidity and reduced credit risk.

In general, although opinion was divided between those commenters who urged caution in proceeding and those who urged the Commission to provide greater regulatory relief, few, if any, were of the opinion that the Commission should refrain from according some form of the proposed relief to markets that limit access to eligible participants. Based upon the agreement of the commenters that the proposed exemption's general direction was correct, the Commission is promulgating final rules adding a new Part 36. These final rules establish a three-year pilot program to permit limited-access contract markets which have differing regulatory requirements, tailored to the nature of the market's participants. However, based upon its careful consideration of all of the comments received, and particularly in light of the many comments received raising technical issues or making specific recommendations regarding various of the proposed rules, the Commission has determined to make various modifications to the proposed rules. These specific modifications are highlighted below, along with a discussion of the corresponding public comment.

[9] Morgan Stanley & Co., Inc. (''Morgan Stanley''), the Securities and Exchange Commission (''SEC''), and the Futures Industry Association (''FIA'') each sent two letters, one on Part 36 and one on Part 35; the CBT sent three.

V. Final Rules

A. Duration and Scope of Exemption

1. Pilot Program

A key feature of the Commission's proposal was its implementation as a three-year pilot program, beginning when the first contract trades pursuant to these rules. *See* Proposed section 36.1(a). The Commission noted that a pilot program would provide an opportunity to test the operation of the exemption, determine the effect of section 4(c) contract market transactions on the integrity of the marketplace as a whole, and determine whether continued trading under the exemption would be in the public interest. The Commission further noted in the Notice of Proposed Rulemaking that it and other agencies had successfully used the concept of a pilot program. For example, the Commission used a pilot program to reintroduce exchange-traded commodity options.[10]

Most commenters supported the concept of implementing the Part 36 exemption provisions on a trial basis. Many agreed with the Commission's reasoning that a pilot program would allow the exchanges to test the operation of the exemption, while also allowing the Commission to assess the impact of the exemption on the operation of the markets as a whole. Some commenters stated that, in light of the legitimate potential regulatory concerns in exempting exchange-traded transactions from substantive provisions of the Act, the use of a pilot program would be an appropriate means of encouraging market innovation without limiting the Commission's ability to add later limitations or modifications as needed to maintain market integrity.

While generally endorsing the concept of a pilot program, several commenters asked the Commission to clarify that ongoing trading activity would not terminate automatically at the end of the three-year period and to clarify the effect on outstanding section 4(c) contract market transactions should it determine to terminate the pilot program. These commenters noted that section 4(c) contract market transactions could be listed for maturities of five years or longer. Market participants, they reasoned, would not be comfortable trading these new instruments if trading possibly could be suspended or terminated prior to the instruments' maturity, leaving no opportunity to unwind open positions. These commenters suggested that the Commission begin its evaluation during the probationary three-year period to avoid any potential disruptions in an established market, and, if the program were not made permanent, provide a mechanism for a smooth transition into the traditional contract market framework. Finally, one commenter suggested that the Commission clarify the criteria it plans to use in evaluating the success of the pilot program.

The Commission continues to believe that the introduction of section 4(c) contract markets on a pilot basis is appropriate. As the Commission stated previously, the trial nature of this program reflects the Commission's belief that the exemption constitutes a significant departure from the regulatory scheme under which futures and option contracts have been trading for over 70 years. The pilot program will enable the Commission to obtain market experience on which to base any permanent program. A pilot program also will permit the Commission to make modifications or adjustments consistent with the program's trading and regulatory experience.

Since section 4(c) contract market transactions might have terms providing for expiration beyond the end of the three-year pilot program, the Commission agrees with the commenters' views on the need for market certainty. Accordingly, the Commission plans to review the program and whether to make it permanent well before the end of the three-year pilot period. As part of its review, the Commission intends to evaluate whether to extend or otherwise alter the exemptive relief granted herein. The Commission also will consider whether to expand the exemptive relief provided by these rules to other transactions or markets. Any Commission decision to terminate the program will be based on a finding that trading in section 4(c) contract market transactions has adversely affected the ability of the Commission to discharge its regulatory responsibilities or the ability of a contract market to discharge its self-regulatory duties under the Act or that a permanent program for such transactions would not be consistent with the public interest and the purposes of the Act. Should the Commission determine to terminate the program, all previously listed section 4(c) contract market transactions would be permitted to continue trading until their expiration; however, no new section 4(c) contract market transactions with more distant expirations could be listed.

2. Scope of the Exemption

a. Scope of the Relief

The Commission set forth the proposed scope of the exemption with respect to section 4(c) contract market transactions in proposed section 36.1(b), stating that each board of trade on which such transactions are traded would be deemed to be a contract market.[11] As such, they would be required to comply with all provisions of the Act and Commission rules, except for those provisions which are ''specifically inconsistent'' with Part 36.[12]

The three petitioning exchanges (CBT, CME and NYMEX) commented that the structure of the proposed exemption created ambiguity with regard to what was included within its scope. The CBT requested that the Commission specify all of the statutory and regulatory provisions superseded by Part 36. In contrast, NYMEX requested that the Commission specify only those sections of the Act and Commission rules to which the section 4(c) exemption would be inapplicable. At a minimum, the CBT suggested that the word ''specifically'' be deleted from the phrase ''specifically inconsistent,'' stating that without that deletion, market participants might be less able to ascertain what legal requirements apply.

The Commission has considered carefully these comments and has determined that the scope of the exemption is generally appropriate, as proposed. If Part 36 does not specifically exempt section 4(c) contract market transactions from a statutory or regulatory provision, there is no exemption from that provision. However, the provisions of Part 36 govern the trading of section 4(c) contract market transactions in the following specified areas: section 36.3 (trading rules); section 36.4 (listing of transactions); section 36.5 (reporting requirements); section 36.6 (registration requirements); and section 36.7 (risk disclosure). Also, section 36.9 provides for anti-fraud and anti-manipulation prohibitions in addition to those

[10] 46 FR 54500 (Nov. 3, 1981).

[11] The Commission's proposal did not limit contract markets eligible to provide a facility for trading in Section 4(c) contract market transactions to current contract markets. New markets wishing to offer a facility for such transactions would be required to comply with those provisions of the Act and Commission rules governing a board of trade seeking an initial designation as a contract market. Accordingly, among other things, a prospective Section 4(c) market must submit all rules relative to matters such as governance, disciplinary and arbitration proceedings, and financial requirements under the current provisions of Section 5a(a)(12) of the Act, 7 U.S.C. 7a(a)(12). 59 FR 54139, 54143, 54144.

[12] 59 FR 54139, 54143, 54151.

applicable to section 4(c) contract market transactions under the Act and Commission Rules 33.9 and 33.10.[13] All other provisions of the Act and Commission rules, including those related to, among other things, segregation of customer funds, adjusted net capital (except for the capital requirements of certain IBs as discussed *infra*), supervision, bankruptcy (see discussion *infra*), exchange emergency actions, reparations proceedings and private rights of action, will continue to apply.

Nevertheless, the Commission, as discussed below, is modifying section 36.3 to provide greater specificity with respect to the trading procedures that are permissible under this exemptive relief. Moreover, in responding to the public comment on the proposed rules, the Commission has provided guidance on the scope and operation of the exemption beyond that which was provided in the Notice of Proposed Rulemaking.

b. Definitions

Several commenters held opposing views regarding the nature of the instruments to be included within the proposed broad definition of ''section 4(c) contract market transaction,''[14] In adopting Part 36, the Commission is exercising its authority under section 4(c) of the Act, 7 U.S.C. 6(c), to exempt certain instruments and transactions from certain provisions of the Act and Commission rules. Accordingly, the proposed definition of ''section 4(c) contract market transaction'' is included to make clear that an election by a contract market to trade an instrument on a section 4(c) contract market pursuant to the Part 36 exemptive system will be deemed to be an election to submit that instrument to the Act and Commission rules in accordance with this Part.[15]

In addition, an industry trade association expressed concern that proposed section 36.1(b) may have created an ambiguity regarding the treatment of these transactions under the United States Bankruptcy Code. According to the commenter, the absence in proposed section 36.1(b) of the words ''designated as'' before the phrase ''a contract market within the meaning of the Act'' could leave open to question the applicability of the special protective provisions[16] of the Bankruptcy Code with respect to commodity broker bankruptcies in the context of section 4(c) contract market transactions.[17]

The Commission intends that its Part 190 Bankruptcy Rules will apply in the context of Part 36.[18] To remove any perceived ambiguity, the Commission is modifying the language of the final rule as suggested by the commenter. Accordingly, the Commission is adding to section 36.1(b) the words ''designated as'' before the phrase ''a contract market within the meaning of the Act.''

c. Eligible Participants

As proposed, the definition of a ''section 4(c) contract market transaction'' included the requirement that an agreement, contract, or transaction be executed by, or on behalf of, an ''eligible participant.'' Proposed section 36.1(c)(2) defined ''eligible participant,'' by setting forth a list of those individuals and entities permitted to trade section 4(c) contract market transactions. This list, with several additions tailored to the operation and structure of this particular market, was modeled on the list of ''appropriate persons'' set forth in section 4(c)(3) (A) through (J) of the Act, and on the definition of ''eligible swap participant'' under Part 35 of the Commission's Rules. However, as proposed, the definition of ''eligible participant'' under Part 36 differed in several respects from the definition of ''eligible swap participant'' under Part 35. The proposed differences related to employee benefit plans, municipalities, and certain types of investment vehicles. The Commission also sought comment on whether the definition of ''eligible swap participant'' under Part 35 should be conformed to the proposed revisions. Many of the comments focused on these proposed revisions, which are discussed in greater detail below.

i. Employee Benefit Plans

As proposed, section 36.1(c)(2)(vii) would have limited employee benefit plans eligible to participate in section 4(c) contract market transactions to those subject to the Employee Retirement Income Security Act of 1974 (''ERISA''), or similar foreign plans, with total assets exceeding $5 million and (rather than the ''or'' provided in section 4(c)(3)(G) of the Act and in section 35.1(b)(2)(vii)) whose investment decisions were made by a bank, trust company, insurance company, investment adviser (''IA'') under the Investment Advisers Act of 1940, or a CTA under the Act.[19] The Commission specifically sought comment concerning whether there is an asset level for an employee benefit plan which should qualify it as an eligible participant irrespective of whether its investment decisions are made by a bank, trust company, insurance company, IA or CTA and whether Part 36 should be conformed to Part 35 in this regard.

Several commenters, including three exchanges, an industry trade association and a bar association committee, stated the view that Part 36 should conform to the existing language of Part 35, so that those currently eligible to participate in swap transactions also could participate in section 4(c) contract market transactions. Moreover, the Department of Labor and the FIA opposed this revision in the proposed rule, reasoning that requiring an employee benefit plan to use a bank, trust company, insurance company, IA or CTA to make its investment decisions with respect to section 4(c) contract market transactions would create burdens for large sophisticated plans that manage plan assets in-house.

The Commission has carefully considered these comments in the context of the Act and Part 35 and does not believe that it should be more difficult for an employee benefit plan to

[13] The remainder of Part 36 sets forth the duration of the exemption (36.1(a)), definitions for purposes of Part 36 (36.1(c)), mandatory conditions and prohibited transactions (36.2) and a procedure for suspension or revocation of the exemption (36.8).

[14] Proposed Section 36.1(c)(1) defined a ''Section 4(c) contract market transaction'' as ''[a]ny agreement, contract, or transaction (or class thereof) entered into on or subject to the rules of a contract market in accordance with the provisions of this Part, and that is executed by a member of the Section 4(c) contract market that is an eligible participant for its own account, or a futures commission merchant or floor broker for its own account or on behalf of an eligible participant.''

[15] Any instrument meeting the criteria of Part 36, except for those specifically excluded thereunder, could be eligible to trade under these rules. *See* H.R. Rep. No. 978, 102d Cong., 2d Sess. 82–83 (1992).

[16] The commenter noted that these provisions are designed to enhance the integrity of the futures markets by preventing the trustee of an insolvent customer or FCM from, among other things, (1) avoiding contractual obligations, (2) rescinding transfers of margins and positions, or (3) impeding the liquidation of defaulted contracts.

[17] *See* 11 U.S.C. 761–766. Presumably, this conclusion could be based upon the Commission's definition of ''commodity contract'' for purposes of its Bankruptcy Rules, which incorporates by reference Section 761(4) of the Bankruptcy Code. *See,* Commission Rule 190.01(g). The Bankruptcy Code defines ''commodity contract'' as a ''contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade'' (11 U.S.C. 761(4) (A) and (D)) and defines a ''contract market'' as a ''board of trade *designated* as a contract market by the Commission under the Act.'' 11 U.S.C. 761(7) (emphasis added).

[18] *See* 59 FR 54139, 54144.

[19] The Commission's proposed asset floor for an eligible employee benefit plan in this context, $5 million, was five times the $1 million asset floor for an employee benefit plan set forth in section 4(c)(3)(G) of the Act, but the same as specified under the Part 35 swaps exemption.

participate in a transaction under Part 36 than in an exempt swap transaction under Part 35. In adopting section 36.1(c)(2)(vii), therefore, the Commission is substituting the word ''or'' for the proposal's ''and.'' Accordingly, employee benefit plans with total assets exceeding $5 million will not be required to have their investment decisions with respect to section 4(c) contract market transactions made by a bank, trust company, insurance company, IA or CTA.

The Department of Labor also objected to the level of the asset floor set forth in proposed Rule 36.1(c)(2)(vii). Although it recognized that this threshold is five times that set forth in section 4(c)(3)(G) of the Act, it stated its belief that $5 million is too low a threshold to be an accurate gauge of sophistication or understanding of complex financial instruments. The Department recommended that the asset floor for an employee benefit plan be $50 million if an outside investment advisor is used and $100 million, otherwise. The SEC, without setting forth a specific dollar amount, also advocated a substantially higher threshold.

The Commission has carefully considered these comments, but does not believe that it is appropriate to make the threshold amount higher for section 4(c) contract market transactions than for OTC transactions exempted under Part 35. However, it should be emphasized that Rule 36.1(c)(2)(vii) sets forth *minimum* standards for eligibility. As the administrator of ERISA, the Department of Labor can establish a higher, controlling standard of eligibility for participation in section 4(c) contract market transactions by employee benefit plans subject to ERISA.[20]

ii. Municipalities

In proposing section 36.1(c)(2)(viii), the Commission questioned whether municipalities should be included as eligible participants and, if so, whether any limitations on their participation would be appropriate. All of those commenting on the issue, except for the SEC, strongly supported the proposed inclusion of municipalities as eligible participants without limitation. An association of state and local government finance officials opined that, although certain government entities have experienced trading losses, municipalities as a class are no more or less sophisticated than other types of eligible investors.[21] Several commenters further reasoned that limitation of the investment authority of municipalities is a function more appropriately reserved to the various states. In contrast, the SEC expressed concern that there are no qualifying standards for municipalities, noting that municipalities are not included in the definitions of ''qualified institutional buyer'' under SEC Rule 144A or ''accredited investor'' under SEC Regulation D.[22]

After carefully considering the comments, the Commission is persuaded that, as a matter of state/Federal comity, it should continue to refrain from precluding the participation of municipalities in exempt transactions. This policy applies both to section 4(c) contract market transactions and to exempt swap agreements under Part 35 of the Commission's rules. Accordingly, the Commission is adopting section 36.1(c)(2)(viii) as proposed.

Nevertheless, the Commission has emphasized in several reports, Congressional testimony and administrative proceedings, that all institutions, including municipalities, need to establish and implement strong internal controls and risk management practices with respect to financial market transactions. The Commission also notes that representatives of the President's Working Group on Financial Markets[23] have met with representatives of various state and local government associations to discuss sharing and disseminating information on appropriate investment guidelines for governmental entities, and to promote their use. The Commission and its staff stand ready to meet with such associations or any other appropriate entity to pursue the development of such guidelines or to otherwise provide information concerning risk management practices relevant to the exchange markets subject to its supervision. The Commission also will provide further guidance on the responsibilities of FCMs for supervision of such accounts.

iii. Other Entities

Proposed Part 36 specifying the list of eligible participants for section 4(c) contract market transactions also included certain technical or clarifying changes from that used in defining eligible swap participants under Part 35. Many, if not all, commenters were of the view, however, that conformity between the two exemptions should be maintained, to the greatest degree possible. In light of these views, the Commission, in adopting section 36.1(c)(2) has attempted to conform the substance, and the language, of Part 36 to that of Part 35, wherever possible. In a few instances, however, the final Part 36 rules do not mirror precisely their counterparts in Part 35.

For example, as proposed, section 36.1(c)(2)(iv) required that to be an eligible participant, investment companies be *regulated* under the Investment Company Act of 1940 (''ICA'') or subject to foreign regulation, provided that such investment company was not formed solely for the purpose of constituting an eligible participant and has total assets exceeding $5 million. This proposed rule differs from its Part 35 counterpart defining investment companies as eligible swap participants by including a $5 million asset floor and by the language requiring that the investment company be *regulated* under the ICA, rather than *subject* to regulation.[24]

In adopting section 36.1(c)(2)(iv), the Commission has modified the proposal to refer to investment companies *subject to regulation* under the ICA, more closely conforming the provision to its Part 35 counterpart.[25] This modification

[20] An association representing state and local finance officers requested clarification whether proposed Section 36.1(c)(2)(vii) included both private and public employee benefit plans. In adopting Section 36.1(c)(2)(vii), the Commission notes that the rule includes the phrase ''subject to ERISA.'' Because ERISA does not cover public employee benefit plans, such plans are not encompassed in Section 36.1(c)(2)(vii), but rather would be included under Section 36.1(c)(2)(viii), as an instrumentality, agency or department of a governmental entity or subdivision, thereof. *See* note 22 *infra*.

[21] Orange County, California, recently suffered trading losses of approximately $1.7 billion, primarily from transactions in government securities and governmental agency obligations and declared bankruptcy in December 1994. The commenter noted, in this regard, that Orange County would have been considered a sophisticated investor by any common measure.

[22] 17 CFR 230.144A and 230.501(1995), respectively. However, any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, shall be deemed a ''qualified institutional buyer'' if it owns at least $100 million in securities of issuers that are not affiliated with the plan, and shall be deemed an ''accredited investor'' if it has total assets in excess of $5 million. 17 CFR 230.144A(a)(1)(i)(D) and 230.501(a)(1)(1995), respectively.

[23] The Working Group includes the Secretary of the Department of the Treasury and the Chairs of the Federal Reserve Board, the SEC and the CFTC.

[24] *Compare* proposed 36.1(c)(2)(iv) with Section 35.1(b)(iv).

[25] The Commission is also adopting similar conforming changes to the language of Section 36.1(c)(2)(v), relating to commodity pools. Specifically, the language requiring that, to be an eligible participant, a commodity pool be formed and operated by a person *regulated* under the Act, is being modified to read *subject to regulation*. The remaining conditions, that the commodity pool is not formed solely for the purpose of constituting an

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will permit hedge funds,[26] which although subject to the ICA are generally excluded from regulation under it, to qualify as eligible participants. The $5 million asset floor, however, which applies to commodity pools under both Part 36 and Part 35,[27] is being adopted under section 36.1(c)(2)(iv).[28] In all other respects the substance of section 36.1(c)(2)(iv), as adopted, conforms to its counterpart under Part 35.

The provisions of proposed section 36.1(c)(2)(vi), which would apply to a corporation, partnership, organization, trust, or other entity, would have required that such an entity not be formed solely for the purpose of constituting an eligible participant, and have either (1) assets exceeding $10 million, or (2) a net worth of $1 million and that the transaction be entered into in connection with the conduct of the entity's business or to manage the risk of an asset or liability owned or incurred in the conduct of the entity's business or reasonably likely to be owned or incurred in the conduct of its business. The proposed Part 36 rule differed from the Part 35 provision in two respects. First, proposed section 36.1(c)(2)(vi) did not include a provision similar to that of section 35.1(b)(2)(vi), which permits the entity to be an eligible swap participant by obtaining a guarantee of the obligation of the party under the swap agreement in lieu of meeting the $10 million asset test. However, because all section 4(c) contract market transactions will be guaranteed by a clearing organization, the ability to obtain a guarantee is not a measure of counterparty creditworthiness, and hence the alternative guarantee test of swap eligibility is inapplicable to section 4(c) contract market transactions. Accordingly, the final Part 36 rule continues, as proposed, to differ in this respect from Part 35.[29]

The second difference between the proposed Part 36 rule and its Part 35 counterpart was a clarification in section 36.1(c)(2)(vi) that commodity pools, investment companies or hedge funds qualify for exemptive relief under the specific eligibility provision applicable to them, and not under the more general provision of subsection (vi). The Commission's inclusion of the phrase ''other than a commodity pool or other collective investment vehicle'' in proposed subsection (vi) was a technical clarification, and was not intended as a substantive change to the exemptive framework.

However, in order to maintain consistency between the language of Parts 36 and 35 to the greatest degree possible, the Commission is not including this additional, clarifying language in section 36.1(c)(2)(vi). Nevertheless, the Commission intends that to be deemed an eligible participant in a section 4(c) contract market transaction, an investment company or a hedge fund must qualify under section 36.1(c)(2)(iv), and a commodity pool must qualify under section 36.1(c)(2)(v). The Commission interprets Part 35 similarly, so that to qualify as an eligible swap participant, an investment company or hedge fund must meet the standards of section 35.1(b)(2)(iv), and a commodity pool must meet the standards of section 35.1(b)(2)(v). These specific provisions are the only avenues through which a commodity pool, investment company or hedge fund can qualify as an eligible participant for section 4(c) contract market transactions under Part 36, or as an eligible swap participant under Part 35.[30]

B. Conditions on Transactions Which Are Included Under Part 36

As summarized above, transactions included within the proposed Part 36 exemption were required to meet a number of additional conditions. Specifically, proposed section 36.2 required that section 4(c) contract market transactions provide for cash settlement, be cleared through a clearing organization, not involve domestic agricultural commodities, not involve a previously designated futures or option contract, and not involve futures or option contracts subject to the provisions of section 2(a)(1)(B) of the Act. The comments submitted on each of these conditions are discussed below.

1. Cash Settlement

The Coffee, Sugar & Cocoa Exchange, Inc. (''CSCE'') objected to the requirement as proposed in section 36.2(a)(1) that the settlement or delivery of section 4(c) contract market transactions be in cash or by means other than transfer or receipt of a commodity. The CSCE opined that requiring cash settlement would limit section 4(c) contract market transactions to economically inferior contracts in those instances where a physical delivery contract may be superior to a cash settled contract. The CSCE further reasoned that because access to section 4(c) contract markets is limited to sophisticated traders, who presumably have greater familiarity with the procedures for making or taking physical delivery, there is less reason to restrict the availability of physical delivery contracts under the exemption.[31]

The Commission disagrees with this view. To the contrary, the Commission notes that, in its experience, most surveillance problems have arisen in the context of market congestion relating to the delivery of physical commodities. Generally, in order to minimize the possibility of market congestion or manipulation, the Commission evaluates the adequacy of deliverable supplies and delivery procedures during its review of contract market

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eligible participant and has total assets exceeding $5 million are already consistent with Part 35, and are being adopted as proposed.

[26] The term ''hedge fund'' is now commonly used to refer to a wide array of private collective investment vehicles, usually organized as limited partnerships and organized so as to avoid the application of most securities laws.

[27] *See,* 17 CFR 35.1(b)(2)(v) (1995).

[28] The $5 million asset floor being adopted under Section 36.1(c)(2)(iv) will apply to hedge funds even though there is no comparable requirement for eligibility under Part 35. The Commission believes, however, that this slight difference in the definitions will not disadvantage any hedge funds seeking to participate in Section 4(c) contract market transactions and provides for consistent treatment under Part 36 for commodity pools and hedge funds with respect to the imposition of an asset floor.

[29] The proposed rules also differed from Part 35 to the extent they did not impose specific financial requirements on floor brokers and floor traders. Such requirements were not imposed based on the Commission's understanding that any floor broker or floor trader would, by necessity, be a member in good standing of the 4(c) contact market whose transactions thereon would be guaranteed by an exchange clearing member. The Commission's understanding in this regard was confirmed by one exchange. A second exchange expressed its view that exchange rules adequately address such financial matters. Accordingly, at this time, the Commission sees no need to impose explicit clearing member guarantee or financial requirements on floor brokers and floor traders.

[30] Section 36.1(c)(2)(vi) cannot be used to abrogate the limits on commodity pool or other collective investment vehicle eligibility. Section 36.1(c)(2)(vi)(B) and (C) only apply to an entity engaged in risk management or commercial conduct that has a principal business other than serving as a passive investment vehicle and is not intended to be available to passive investment vehicles like commodity pools, investment companies or hedge funds. *See also,* Section 35.1(b)(2)(vi)(C).

[31] A commenter stated that a physical delivery commodity futures contract, in fact, may require that certain documents, rather than the actual commodity itself, be transferred at the time of delivery. The commenter noted that these documents create a subsequent contractual agreement to deliver the physical commodity and therefore such contracts should be eligible to trade as Section 4(c) transactions. The Commission disagrees. Most ''physical delivery'' contracts provide for the transfer of documents (*e.g.,* warehouse receipts, shipping certificates, vault receipts, etc.) as part of the delivery process. However, the ultimate satisfaction of such contracts is by physical delivery of the commodity pursuant to exchange-specified rules. Thus, the fact that documents are transferred as a means of executing the delivery process does not qualify such contracts for Section 4(c) transactions, because settlement ultimately would *not* be in cash or means other than transfer or receipt of a commodity, as required by Rule 36.2(a)(1).

applications for designation. Section 4(c) contracts, however, will not be required to undergo such a review process. Accordingly, the Commission believes that restricting eligible section 4(c) contract market transactions to those that do not involve physical delivery of a commodity is a prudent measure to mitigate concerns regarding the delivery process and deliverable supplies. That is not to say, however, that after gaining experience with the trading of section 4(c) contract market transactions during the pilot program, the Commission will not revisit this issue for all, or certain classes of, commodities.

The proposed limitation on the physical delivery of commodities on section 4(c) contract market transactions did contain an exception for the physical delivery of a ''major foreign currency.'' The CME suggested that the restriction of this exception to ''major'' foreign currencies should be removed from the final regulations. It reasoned that the need for risk management by participants in markets for many of the ''non-major'' currencies is as great, if not greater, than in the major currency markets. In its view, the rule, at a minimum, should be revised to clarify the meaning of ''major currency,'' a term otherwise undefined in the proposed rules. The CME suggested that ''major'' currencies include all currencies for which there are no legal impediments to delivery or cash settlement and in which a sufficiently liquid spot market exists.

The Commission disagrees with the commenter that physical delivery should be permitted on a section 4(c) contract market for any foreign currency, no matter how thin its cash market. To the contrary, the cash market for a foreign currency must be sufficiently liquid and unimpeded by legal restraints to permit its ready delivery. Otherwise, the contract would be susceptible to manipulation, price distortion or default. Indeed, it was based upon this reasoning that the Commission initially proposed to limit the exception to physical delivery of ''major foreign currencies.''

However, the Commission agrees that the proposed rule's use of the undefined term ''major currency'' needs clarification. The final rule, therefore, substitutes the descriptive criteria suggested by the commenter for the term ''major currency.'' That is, physical delivery is permitted in section 4(c) contract market transactions for foreign currencies which have no legal impediment to such a delivery and for which there exists a sufficiently liquid cash market.

2. Clearing and Related Financial Integrity Issues

a. Clearing

Because the exemption deems all section 4(c) contract markets to be designated as contract markets, the Commission also proposed to require that section 4(c) contract markets maintain a clearing facility subject to Commission oversight, and that the rules of the clearing organization be submitted to the Commission for approval pursuant to section 5a(a)(12)(A) of the Act.[32] The Philadelphia Stock Exchange (''PHLX''), commented that the Commission should apply this requirement ''flexibly.'' According to the PHLX, the Commission should permit, for example, transactions cleared by a registered securities clearing agency pursuant to a comparable regulatory scheme.

As the Commission noted in its Notice of Proposed Rulemaking, in proposing these rules it did not intend:

> to limit contract markets in section 4(c) contract market transactions to current contract markets or exchanges. In order to qualify, such an entity would be treated similarly to a board of trade seeking an initial designation as a contract market.

59 FR at 54144. Nevertheless, the Commission believes that all section 4(c) contract markets should be subject to direct Commission oversight and enforcement of all of the self-regulator's rules, particularly those regarding the financial integrity of the transactions. Accordingly, although a clearing agency registered under a comparable regulatory scheme such as that administered by the SEC would be eligible to clear section 4(c) contract market transactions under Part 36, the entity would, nonetheless, also be required to qualify as a clearing organization under the CEA and Commission rules, clear for a board of trade which has been designated as a section 4(c) contract market, and submit its rules for approval to the Commission pursuant to section 5a(a)(12)(A) of the Act.

In addition to those questions relating to the clearing of section 4(c) contract market transactions,[33] several commenters raised a variety of issues relating to the financial integrity requirements applicable to all designated contract markets. Under the proposed pilot program, these financial integrity requirements would be applied to section 4(c) contract markets. Commenters noted that the Commission did not propose, in the context of this section 4(c) exemption, any modifications to these requirements and requested various forms of relief.

b. Segregation of Customer Funds

For example, the CME, both in its petition and in its comments on proposed Part 36, asserted that the requirement of Commission Rule 1.20 to segregate all customer funds is not necessary to ''the smooth and safe functioning of the Rolling Spot Futures Contracts.''[34] However, segregation of customer funds is a cornerstone of the Commission's customer protection and financial integrity framework. In light of its importance to safeguarding customer funds, the Commission is not prepared to grant relief from the segregation requirement.

The CBT requested that the Commission grant an exemption for section 4(c) contract market transactions from Commission Rule 1.25, which the CBT describes as a rule prohibiting an FCM from investing customer funds in anything other than U.S. government securities.[35] The CBT views the permissible investments under Rule 1.25 as unduly restrictive and stated that there are other liquid investments, such as corporate investment grade bonds, that would be safe, appropriate investments of customer funds. The CBT stated that exchanges should be allowed to determine how customer funds deposited with an FCM in connection with trading on these exempt markets can be invested.[36]

[32] The term ''contract market'' includes a clearing organization that clears trades for the contract market. Commission Rule 1.41(a)(3).

[33] The CME suggested that the Commission permit the clearing of Part 36 transactions on a faster schedule or otherwise in a more innovative fashion than that provided for traditional designated contract markets. This issue is discussed below, as it relates to trading rules. As a general matter, however, the Commission believes that, for all markets, whether traditional or exempt under Part 36, an expeditious clearing system, by reducing the time during which transactions are unsettled and the parties at risk, is crucial to minimizing systemic risks. Accordingly, although Section 4(c) transactions generally may be part of the same clearing regimen as non-exempt transactions, nothing in the Part 36 rules would prohibit faster or more innovative clearance of these instruments.

[34] 58 FR 43424–25.

[35] In fact, Rule 1.25 also permits customer funds to be invested in certain municipal securities, subject to staff interpretations that such investments must be liquid. Rule 1.25 provides in pertinent part that ''[n]o [FCM] and no clearing organization shall invest customer funds except in obligations of the United States, in general obligations of any State or any political subdivision thereof, or in obligations fully guaranteed as to principal and interest by the United States.'' *See also* CFTC Interpretative Letter No. 86–21, [1986–1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶23,266 (Sept. 17, 1986).

[36] As an alternative to exemption from Rule 1.25, the CBT suggested that the Commission specify an expanded range of permissible investments of customer funds. If this approach were adopted, the

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The Commission believes that it is inappropriate to grant the requested relief from Rule 1.25 at this time. That rule derives from the statutory limitations set forth in the final proviso of section 4d(2) of the Act. The investment limitations are intended to assure that the pool of customers' funds remains safe, liquid and available for distribution to customers on demand or, following an FCM's bankruptcy, to facilitate transfers to another firm should that become necessary.

The Commission envisions that customer funds related to section 4(c) contract market transactions will be commingled with other customer funds in a combined pool of segregated funds and would be treated as funds of customers involved in traditional futures contracts in the event of an FCM's bankruptcy. Therefore, it is inappropriate and impracticable to apply provisions different from the general provisions of section 4d(2) of the Act and Commission Rules 1.20–1.30, 1.32 and 1.36 concerning segregation of customer funds to section 4(c) contract market transactions. However, as a consequence of the failure of Barings PLC, the Commission, joined by regulators and self-regulators worldwide, currently is reviewing the safeguarding of customer funds, both domestically and internationally, to determine if statutory or regulatory changes are appropriate.

Two commenters also suggested that required subordination agreements relating to customer funds held in foreign depositories be limited. In 1988, the Division of Trading and Markets issued Financial and Segregation Interpretation No. 12 to permit funds of United States-domiciled customers to be segregated in foreign depositories subject to conditions intended generally to prevent the dilution of customer funds held in segregation in the United States in the event that an FCM holding segregated funds offshore became bankrupt.[37] Among other requirements, the FCM must obtain a customer's authorization to deposit its funds into a foreign depository. The customer also must agree in writing that, in the event the FCM is placed in bankruptcy and there are insufficient funds in a foreign currency to satisfy customer claims in that currency, the customer will subordinate its claim attributable to funds held offshore in that particular foreign currency to the claims of customers whose funds are held in dollars or other foreign currencies.

Commenters also suggested that the Commission limit the applicability of the subordination requirement of Interpretation No. 12 with respect to section 4(c) funds. Specifically, one commenter suggested that a subordination agreement should be required only in ''cases where access to funds held in a foreign depository is subject to potential restriction by foreign governmental authorities or agencies.''

The Commission believes that there is no basis for applying a different standard in requiring subordination of section 4(c) and non-section 4(c) segregated funds. However, as noted above, the Commission is reviewing this and other requirements contained in Interpretation No. 12 in response to the recent collapse of Barings and to address issues that have developed since Interpretation No. 12 was first published.[38] Any revision of the current safeguards for funds held outside the United States on behalf of customers trading on futures exchanges in the United States likely will be uniform across section 4(c) and non-section 4(c) contract markets.

c. Margining of Customer and Proprietary Accounts

Two commenters raised issues regarding the margining of section 4(c) contract market transactions. One commenter recommended that the Commission permit eligible participants initially to cross-margin section 4(c) contracts, and subsequently to cross-margin section 4(c) and non-section 4(c) contracts. Although the Commission has not provided for cross-margining as part of this rulemaking, the Commission would consider such a feature as part of the pilot program. In this connection, the Commission notes that it has approved numerous cross-margining plans for exchange trading, beginning in 1988. Accordingly, the Commission encourages interested persons to submit a detailed petition for such a plan during the course of the Part 36 pilot program.

The second commenter suggested that the Commission allow ''futures-style'' margining for option contracts. Futures-style margining would permit the initial purchase of option contracts with a performance bond or margin payment as currently permitted for futures contracts, rather than with full payment of the option premium.

Commission Rule 33.4(a) requires payment of the full amount of each option premium at the time the option is purchased. After that rule was adopted, the issue of whether ''futures-style'' margining is also appropriate for options was raised, culminating in publication in the Federal Register of two petitions to repeal Rule 33.4(a)(2).[39] Although a number of supportive comments were submitted, many also opposed the concept. The pilot program for the trading of section 4(c) contract market transactions presents an ideal opportunity to test prudently, within the confines of a limited-access market, the potential benefits and risks of futures-style margining. Accordingly, the Commission has determined, in principle, to permit ''futures-style'' margining for section 4(c) option transactions under the Part 36 pilot program, and will consider any such proposals submitted.

Finally, an investment banking firm requested clarification of several technical issues relating to financial integrity requirements. Specifically, it inquired regarding the terms on which an FCM may transfer excess funds[40] belonging to the same customer from an account containing section 4(c) contract market transactions to an account containing traditional contracts, *e.g.*, whether a separate signature is required. Because the Commission will treat customer funds related to section 4(c) contract market transactions the same as those of traditional futures contracts for segregation purposes, it would be unnecessary to maintain separate accounts for section 4(c) and traditional contracts of the same customer.

The commenter also expressed the view that although customer and proprietary positions in section 4(c) contract market transactions should be accounted for in the same fashion as in non-exempt futures and option contracts, to the extent that positions in section 4(c) contract market transactions may be margined differently than non-exempt futures and options transactions, a different adjusted net capital treatment might be appropriate. The Commission reiterates that the general financial and segregation rules applicable to non-exempt futures and

CBT believes it should be available with respect to all funds deposited with an FCM by an eligible participant under Part 36, without regard to whether the customer is trading exempt or traditional contracts.

[37] 53 FR 46911 (Nov. 21, 1988), *reprinted in 1* Comm. Fut. L. Rep. (CCH) ¶7122. Prior to 1988, the Commission required segregated funds to be held in the United States except for certain funds of foreign-domiciled customers.

[38] For example, the Federal Reserve Board did not allow banks in the U.S. to accept deposits denominated in foreign currencies until January 1990.

[39] See 54 FR 11233 (March 17, 1989).

[40] The commenter did not define the term ''excess funds.'' The Commission uses the terms ''excess funds'' and ''free funds'' to mean the amount by which the net liquidating equity in an account exceeds the initial margin requirement for the positions in that account.

option contracts will apply in the same manner to section 4(c) contract market transactions.[41]

3. Excluded Commodities

The scope of the section 4(c) exemption was proposed to be further limited by its inapplicability to transactions in certain, identified commodities and by the general restriction that a section 4(c) contract market transaction could not be offered for a contract previously designated as a traditional contract market. Two commenters objected to section 36.2(a)(3)'s proposed prohibition of section 4(c) contract market transactions on specified domestic agricultural commodities.[42] The CME and the CSCE noted that the Commission did not propose to prohibit section 4(c) trading in many other physical commodities already trading as non-exempt futures and options, such as sugar, coffee, copper, crude oil, lumber, and scrap metal. Any distinction between these two classes of physical commodities, according to the commenters, would be artificial.

The Commission disagrees. The commodities excluded from eligibility under proposed section 36.2(a)(3) are those agricultural commodities specifically enumerated in section 1a of the Act. The Commission is of the opinion that these commodities share certain characteristics relating to their underlying cash markets and the seasonality of their production, which make different treatment appropriate. As the Commission noted in the Notice of Proposed Rulemaking, the enumerated agricultural commodities are treated differently, as a class, in other contexts, as well. For example, the Commission directly administers speculative position limits under Part 150 of its rules only for these commodities. In light of the apparent ability of the currently designated contract markets in these commodities to fulfill the price basing and hedging needs of market users and the untested operation of the Part 36 rules, the Commission believes that caution requires that these commodities be excluded from the pilot program. The Commission will reconsider this determination when it evaluates the success of the pilot program.

The Commission also proposed to exclude any transaction subject to section 2(a)(1)(B) of the Act, 7 U.S.C. 2, including stock index futures contracts, from the scope of the exemptive rules.[43] In contrast to the SEC, which specifically concurred with this part of the proposal, PHLX commented that:

> nothing in the section 2(a)(1)(B) limitation on section 4(c) [prevents] the Commission from permitting a securities exchange that obtains a designation tailored to its special circumstances or a contract market affiliate of a securities exchange to trade stock index futures contracts or analogous products meeting the special criteria for futures contracts on groups or indexes of securities in a securities-style environment pursuant to the requirements of the 1934 Act, as long as the SEC has an opportunity to express its views on such contracts in accordance with the provisions of section 2(a)(1)(B).

Accordingly, PHLX asserted that the proposed exclusion of section 2(a)(1)(B) commodities was overly broad and should be narrowed or deleted in the final rules and that these issues be addressed in the context of individualized requests for exemptive relief.

Section 2(a)(1)(B) commodities raise particular issues in light of the nature of the underlying cash market and the special procedures that apply to designation of these commodities. Accordingly, the Commission continues to believe that inclusion of these commodities in a pilot program is inappropriate and has determined not to further revise section 36.2(a)(5) at this time. The Commission may reconsider the issue in the future, depending upon its regulatory experience.

More generally, the Commission proposed to limit section 4(c) contract market transactions to transactions which do

> not involve any commodity futures contract or commodity option for which any board of trade has been designated by the Commission * * * prior to its application to trade as a section 4(c) market transaction, unless it can reasonably be distinguished * * * based on its hedging function and/or pricing basis.[44]

The Commission explained that it will base determinations as to whether proposed section 4(c) contract market transactions can be ''reasonably distinguished'' from existing contracts on the same considerations that it now applies in deciding whether proposed futures and options contracts are treated as separate designation applications, and provided several examples of instruments that are ''reasonably distinguishable'' from existing contracts. 59 FR 54145.[45] Nevertheless, several commenters complained that the Commission's inclusion of examples of acceptable section 4(c) contract market transactions is not adequate to prevent misapplication or misinterpretation of the rule's terms. They suggested that the rule be amended to set forth a brighter line delineating those transactions which could be traded under Part 36.

The Commission believes that further enumeration of specific standards or commodity characteristics defining the universe of permissible section 4(c) contract market transactions would unnecessarily restrict the exchanges' and the Commission's flexibility for innovation under the proposed rules. Because the universe of eligible section 4(c) contract market transactions is so broad—including a wide range of diverse tangible commodities, financial instruments and indexes—a comprehensive listing of eligibility standards likely would be incomplete, failing to address questions regarding novel section 4(c) contract market transactions that may be designed in the future. Moreover, a detailed listing of eligibility requirements could have the unintended effect of excluding certain types or classes of contracts or commodities from the exemption. For these reasons, the Commission believes that a broad standard based on two fundamental economic characteristics of futures contracts—their hedging function or the basis on which they are priced—will provide maximum flexibility to the exchanges in

[41] For example, the same distinctions between customer and proprietary transactions will apply for segregation and adjusted net capital purposes, so that the amount of customer funds related to Section 4(c) transactions will be included in the calculation of an FCM's minimum adjusted net capital requirement. Proprietary positions in such transactions will be subject to the same haircuts as proprietary positions in traditional contracts when an FCM computes its adjusted net capital. To the extent that Section 4(c) contract market transactions result in more long-dated transactions or in transactions with features, such as embedded options, which are substantially different from customary futures contracts, the Commission will reassess the continued efficacy of its capital requirements and make appropriate adjustments. Separately, the Commission may consider whether adjustments are appropriate in light of responses to the SEC's concept release on capital. 58 FR 27486 (May 10, 1993). In addition, the Commission recently held a roundtable on capital issues, generally.

[42] The rule, however, does allow for Section 4(c) transactions on a broad index of these enumerated commodities.

[43] See Proposed Section 36.2(a)(5). See also 59 FR at 54145.

[44] Proposed Section 36.2(a)(4) is intended to address, among other things, the concerns expressed by some commenters regarding the problems of a two-tier marketplace. Although the CME and CBT have indicated that they do not intend to trade the same contract on both a Section 4(c) contract market and a traditional contract market, this provision would prevent a Section 4(c) contract market transaction from trading if the same traditional contract were already trading on a contract market.

[45] In that regard, however, Section 36.2(a)(4) specifically states that five- and ten-year interest swap futures and option contracts, rolling spot and currency forward futures and option contracts and flexible options may be listed as Section 4(c) transactions.

developing new section 4(c) contract market transactions, while maintaining the goal of the rule to avoid two-tiered, identical markets trading under two differing regulatory regimes.[46]

On a related issue, the CME suggested that even if the Commission concludes that the proposed standard separating exempt and non-exempt markets were appropriate, the mere existence of a similar, previous contract market designation is an overly-broad criterion. The comment suggested that the prohibition should apply only to contracts that have open interest at the time a Part 36 market proposes to list the section 4(c) transaction; otherwise, competing exchanges could stymie innovation by obtaining traditional contract market designations for markets which are never listed for trading.

The Commission agrees that this comment has merit. The Commission intends that the above provision only limit the trading of two-tiered markets, and does not intend for it to be a means of forestalling competition. Accordingly, the Commission is modifying the restriction, limiting the availability of the Part 36 exception only to contracts that are trading at the time a board of trade proposes to list for trading a section 4(c) contract market, rather than to all designated contract markets. Traded contracts are those in which any transactions occurred during the six complete consecutive calendar months preceding the date of application to trade a section 4(c) contract market.[47]

4. Speculative Position Limits

Finally, an exchange commenter opined that the Commission should exempt section 4(c) contract markets from the requirement under Rule 1.61 that they set and administer speculative position limits. The commenter reasoned that enforcing speculative limits would serve little purpose in light of the requirement that all section 4(c) contract markets (except for foreign currencies) be cash-settled.

As the Commission articulated in the Notice of Proposed Rulemaking, Commission Rule 1.61 already is applied quite flexibly, permitting the exchanges to substitute various position accountability rules for speculative position limits for many futures and option contracts. However, commenters have argued forcefully that OTC markets and foreign exchanges enjoy a competitive advantage by generally not providing for any type of position accountability or position limit rules. The Commission, nevertheless, continues to believe that these types of rules provide the exchanges with a useful and flexible tool for addressing market surveillance concerns.

In any event, based upon the continuing perception of some industry sources that the existence of these rules on U.S. futures exchanges is an actual source of competitive disadvantage, the Commission, by adding a new subsection (b) to section 36.2, is exempting section 4(c) contract markets from the requirements of Rule 1.61. However, the decision of an exchange to discard this particular device from its surveillance tool chest does not, in any way, diminish the exchange's responsibilities under the Act to assure orderly markets. Accordingly, exchanges remain free, as a matter of exchange discretion, to apply position accountability or speculative position limit rules to section 4(c) contract markets.

C. Trading Rules and Procedures

1. The Proposed Rule

Proposed section 36.3 would have permitted a board of trade to submit for Commission approval flexible trading procedures for section 4(c) contract market transactions which were not required to comply in all respects with existing competitive trading requirements and other trading standards relative to the exposure of orders and trades. The proposal represented a substantial change in the principles underlying the required method of trading futures and futures option contracts in that it would have allowed the execution of section 4(c) contract market transactions without exposing such transactions to competition in the pit. The proposal would have permitted exchanges, under a pilot program that would provide some relaxation in competitive trading requirements for certain market participants, to develop new trading procedures designed to address the needs of their increasingly institutional market participants and to compete more aggressively with the OTC market. The proposal also would have required exchange compliance with certain regulatory safeguards in order to maintain essential market and appropriate customer protection.

After reviewing the comments to proposed section 36.3 and customer protection rules in other markets, the Commission has determined to adopt section 36.3, modifying it from the proposal to address certain comments. As adopted, section 36.3 provides a framework of safeguards intended to set forth non-exclusive conditions for the execution of section 4(c) contract market transactions. Section 36.3 would permit expeditious review of exchange rules without prejudicing the ability of the exchanges to request Commission approval of other procedures pursuant to the usual rule approval procedures under section 5a(a)(12)(A) of the Act and Commission Rule 1.41(b). Effectively, the Commission is establishing a framework of safeguards for transparent, negotiated off-floor/ex-pit trading. Experience with the permitted procedures may be required to determine whether other or different limitations are necessary or whether the type of activity that should be deemed to be in violation of the applicable anti-fraud rule should be further specified. Therefore, the Commission intends to evaluate its experience with contract market rules adopted under section 36.3 twelve months after such rules become effective and to propose, if necessary, modifications or limitations to the parameters for section 4(c) trading rules set forth herein to address any market problems which it observes.

Paragraph (a) of proposed section 36.3 provided that a board of trade could submit for Commission approval section 4(c) contract market trading rules to permit trading procedures for section 4(c) contract market transactions that do not satisfy all of the requirements of Commission Rules 1.38(a), 1.39, 155.2, 155.3 and 155.4. Paragraph (b)(3) of the proposed regulation, however, required compliance with Commission Rules 155.2, 155.3 and 155.4 to the extent applicable.

[46] One commenter specifically requested that the Commission clarify whether a contract based on cash-settled North Sea crude oil or a contract based on cash-settled West Texas Intermediate (WTI) crude oil would be considered ''reasonably distinguished'' from the existing light sweet crude oil futures contract which provides for physical delivery of, and for which the pricing basis represents, WTI. Regarding the former, North Sea crudes are distinct from WTI, having different (albeit related) pricing characteristics, so that a WTI-based crude oil contract may not meet the hedging needs of firms having positions in North Sea crudes. Accordingly, Section 4(c) transactions would be permitted for cash-settled North Sea crude oil, since the hedging and pricing functions of these transactions would be distinguished from the existing designated WTI-based crude oil contract. In contrast, a cash-settled WTI crude oil contract would not be permissible, since there should be no material difference in the pricing basis of the contracts (both would reflect the value of WTI crude oil at Cushing, OK) and the hedging uses provided by each contract would be identical.

[47] The six-month period is consistent with the time period specified in Commission Rule 5.2 for classifying designated contract markets as ''dormant,'' after which Commission approval is required to reactivate trading. However, the Commission is not including as a condition for Section 4(c) eligibility, Rule 5.2's five-year grace period, which commences at designation, during which a designated market is exempt from being considered ''dormant.''

2. Specific Exemptive Relief

Two commenters requested that the Commission provide increased specificity with regard to the kinds of transactions that could be executed using section 4(c) contract market trading procedures. Specifically, the FIA stated that it would be helpful ''if the Commission would further set out the kinds of core trading practices it believes would be acceptable in the exempt exchange markets.'' The CBT stated that the ''proposal would be greatly improved if the agency could provide some concrete idea of the kinds of procedures that would be acceptable under the exemption.'' The CBT further recommended that the Commission make explicit in its exemptive relief whether trading opposite customer orders and matching trades between customers or between customers and FCMs would be permitted.

The Commission believes that these comments have merit and has modified the trading rules requirements to provide explicit relief in the form of a safe harbor from the requirements of sections 4b(a)(iv), 4b(b) and 4c(a) of the Act, 7 U.S.C. 6b(a)(iv), 6b(b), and 6c(a), and Commission Rules 1.38(a), 1.39, 155.2, 155.3 and 155.4 for section 4(c) contract market transactions executed using ''special execution procedures'' in accordance with exchange rules that meet certain standards and are permitted to become effective by the Commission. For section 4(c) contract market transactions, such special execution procedures could permit noncompetitive bids, offers, negotiation and/or execution of such orders and transactions.

Subject to the requirement that they satisfy certain specified Commission recordkeeping and audit trail requirements, the Commission would allow exchange rules providing special execution procedures to become effective. These special procedures would permit a member to trade for his own account opposite the account of another member,[48] permit an FCM or floor broker to take the opposite side of a customer order for its own account, or permit the execution of customer orders of different principals directly between customer accounts.[49] The Commission also would allow to become effective exchange rules that permitted the execution of section 4(c) contract market transactions using any combination of special execution procedures and competitive on-floor trading procedures provided that certain additional requirements were satisfied.[50]

Exchanges also may submit for Commission review and approval, pursuant to the usual rule approval procedures contained in section 5a(a)(12)(A) of the Act, and Commission Rule 1.41(b), other section 4(c) contract market rules which do not conform to the specific trading standards set forth in section 36.3 and which do not satisfy the requirements of the Act and Commission regulations with regard to competitive trading requirements and other trading standards relative to the exposure of orders and trades.

In this regard, the Commission has provided greater specificity to give further content to the type of flexibility it intends to provide the exchanges to adapt trading procedures to new products, technology and market circumstances without sacrificing important customer and market protections. For example, it is the Commission's belief that boards of trade designated as section 4(c) contract markets could have market makers with affirmative obligations, specialist systems, ''all or nothing'' large-trader execution procedures and other trading procedures currently not necessarily consistent with Rules 1.38 and 1.39. The Commission would, however, expect the exchanges to have procedures to protect the integrity of pricing and to monitor compliance with the conditions and limitations of the relief as set forth herein, consistent with the affirmative obligations of exchanges to enforce compliance with existing exchange and Commission rules.

a. Recordkeeping and Audit Trail Requirements

As previously stated, all transactions executed using special execution procedures must satisfy certain recordkeeping and audit trail requirements. Paragraph (e)(1) of section 36.3 requires that the contract market provide for record maintenance and retention consistent with Commission Rule 1.31. The audit trail for all transactions executed using special execution procedures must meet the books and records, trade register, trade timing, and contract market oversight requirements of Rules 1.35(a), (e), (g) and (i), respectively.[51] In addition, the recordkeeping requirements set forth in Commission Rule 1.38(b), which requires the special identification of such transactions, must be satisfied for all transactions executed using special execution procedures. This is intended to permit identification of such transactions as different from regular contract market transactions for price discovery purposes.

b. Customer Orders and Disclosure Requirements

Customer orders that could be executed using special execution procedures, *i.e.,* where the FCM or floor broker takes the opposite side of a customer order for its own account or executes orders directly between customer accounts of different principals, would be required to satisfy certain recordkeeping and disclosure requirements in lieu of those now set forth in Commission Rules 1.39, 155.2, 155.3 and 155.4, but in addition to those required where members trade opposite each other.

The exchanges' rules must prohibit the FCM or floor broker from disclosing customer order information for purposes other than to facilitate the execution of that order. The exchanges' rules also must require that an FCM or floor broker provide certain disclosure to affected customers. Before the FCM or floor broker executes the first transaction using special execution procedures for a particular customer, he must provide the customer with a description of such procedures and, in particular, describe how such procedures differ from competitive on-floor trading procedures. The Commission believes that the FCM or floor broker should be required to make such disclosure to the customer only once, prior to the first transaction executed under such procedure for that customer, and that the disclosure should focus primarily on the differences relative to the method of determining the price at which the transaction is to be executed. Thus, although permitting certain practices which currently are prohibited in the exchange environment, these rules nevertheless will provide a greater degree of regulatory protection than is the case for similar OTC transactions.

FCMs and floor brokers executing customer orders also would be required to satisfy certain audit trail and recordkeeping requirements in that the FCM or floor broker must create and maintain a written record, such as an office order ticket, reflecting each customer order. The record must

[48] Section 36.3(b).

[49] Section 36.3(c).

[50] Section 36.3(d). Any section 4(c) contract market transactions executed competitively on-floor must comply with applicable Commission regulations and exchange rules that currently govern competitive on-floor trading.

[51] In order to meet the trade timing requirement for transactions executed using special execution procedures, the contract market rule must specify that the actual time of execution must be recorded and reported to the exchange immediately following the execution.

include customer account identification, order number, time of order receipt and, in addition, must include in the terms of the order, some price-specific instruction provided by the customer.

The Commission is adding the requirement that the customer provide some price-specific instructions or indications to assure that the customer has had an opportunity to determine a price at which the transaction should be executed, in that exchange markets, unlike OTC markets, contemplate agency as well as principal-to-principal transactions. The Commission notes that, unlike trading on most other markets and the futures exchanges,[52] there will be no published or otherwise open or publicly, readily available bid or offer prices for transactions executed using special execution procedures.[53] The only pricing data that would be publicly available to the customer is the post-execution report of previous transactions, required to be disseminated by paragraph (e)(2) of Rule 36.3.[54]

Under these circumstances, the Commission believes that requiring some price indication, rather than just specifying ''market price,'' for instance, provides a means to help the customer determine whether the FCM or floor broker is fulfilling his fiduciary duty to exercise due diligence in the execution of the customer's order. It also is intended to improve the enforceability of section 36.9, which prohibits fraud and manipulation in connection with section 4(c) contract market transactions.

The customer-provided, price-specific information could take various forms. A ''limit order'' or an order that contains a specific, negotiated price at which the customer wants the order to be executed may be examples of such information. A customer-provided maximum price on a buy order or minimum price on a sell order also would fulfill the requirement. In addition, where special execution procedures may be used to fill large orders that cannot be filled in a single transaction, thereby requiring partial executions at different times and prices to obtain a complete fill, a customer-provided range of acceptable prices at which transactions could be executed to fill the order would meet the requirement.

In proposing section 36.3, the Commission indicated that regulations for which exchange alternatives could be submitted include the audit trail requirements of Commission Rule 1.35.[55] A Commission Administrative Law Judge urged the Commission not to amend Commission Rule 1.35(a–1), which generally requires FCMs, introducing brokers and contract market members to identify customer accounts upon receipt before the trades are executed.[56] According to this commenter, ''[e]ven the most sophisticated clients will be unable to protect their own interest if the Commission omits th[is] very tool such clients would use to detect fraud.''

The Commission agrees that customer account identification can be an important component in detecting customer abuse. The information required to be recorded on the written record that must be created by the FCM or floor broker for each section 4(c) contract market customer order exceeds that required by Commission Rule 1.35(a–1). In addition to account identification, order number and time of order receipt, the written record must include the terms of the order, including, as previously discussed, some price-specific instructions from the customer.

c. Combination Transactions

Paragraph (d) of section 36.3 provides that if they meet certain additional requirements, section 4(c) contract market rules could permit transactions to be executed using a combination of special execution procedures and competitive on-floor procedures. The exchange could require, for example, that some, or all, of any section 4(c) contract market transactions negotiated using special execution procedures be exposed to the floor for execution.[57] In this regard, the CSCE commented

The Commission believes, however, that the exchanges should be free to develop approaches that would best serve the identified needs of their customers consistent with the rule. In this connection, exchange rules permitting the use of combined procedures would be required to set forth the circumstances under which such transactions could or should occur competitively on-floor, *i.e.*, under what conditions, when, and to what extent any portion of a section 4(c) contract market order should be exposed to the pit.

Of course, each exchange will continue to have an affirmative obligation under sections 5 and 5a of the Act and Commission Rules 1.51 and 1.52 to carry out a program for the enforcement of its rules relating to the trading of section 4(c) contract market transactions. This includes, in particular, those rules relating to special execution procedures and the associated procedures that the exchange has in place to address the maintenance of orderly markets which are free from fraud and other abuses. As stated above, the Commission will evaluate its experience with section 4(c) contract market transaction special execution procedures after their implementation and determine whether further specific guidance is necessary or appropriate.

In addition, exchange rules that permit section 4(c) contract market transactions to be executed using any combination of special execution procedures and competitive on-floor procedures must provide that any transaction executed using special execution procedures must be in compliance with the requirements of paragraphs (b) and (c) of section 36.3, discussed above. As previously stated, any section 4(c) contract market transaction executed competitively on-floor must comply with applicable

[52] Trades executed directly between customers, in the securities ''fourth market,'' do not have any price reporting or other pricing requirements.

[53] Unlike auction markets or markets with designated market makers, prices for transactions using special execution procedures would be determined through negotiation. Nonetheless, Exchange rules could require that members maintain and disseminate bid and offer prices.

[54] Certain trades executed by affiliated investment companies, however, have a pricing restriction imposed by Regulation 17a–7, 17 CFR § 270.17a–7 (1995). Under this regulation, transactions that are (1) at current market prices, (2) between certain affiliates, and (3) reviewed by the affiliates' boards, are exempt from the prohibition against affiliated investment company transactions contained in Section 17 of the Investment Company Act of 1940. Pension law also imposes some restrictions on transactions between affiliated entities. The exchanges may want to impose their own restrictions on the pricing of affiliated transactions in this market in order to attract customers who operate under such restrictions.

[55] 59 FR at 54145.

[56] This commenter also made a passing reference to Rule 1.35(a-2), but did not provide any further explanation.

[57] New York Stock Exchange (''NYSE'') Rule 76, which governs cross trading, requires that a member who has set up a block trade and is bringing it to the floor to be crossed first announce the proposed bid, offer, and transaction size to the floor. The member must then wait a reasonable amount of time to allow the ''crowd'' (including specialists) to trade against either side before completing the transaction. In addition, NYSE Rule 127 provides that members who bring block trades to the floor that are priced outside current quotations must permit the crowd to participate in a portion of the block. *See also* NYSE Rule 72, which provides priority to an agency cross transaction where both orders consist of 25,000 shares or more. *See also* SEC Release No. 34–35837 (June 12, 1995)(order approving proposed NYSE rule changes that prevent members with knowledge of block orders for execution after the close from effecting transactions in that stock with the intention of reversing the position by participating in the contra-side of the block trade and that require members to establish and maintain procedures reasonably designed to review block trading activities). that ''it is inappropriate, in the case where transactions can occur both in the pit and off the floor, to not require a potential trade to be exposed to the pit.''

Commission regulations and exchange rules that currently govern competitive on-floor trading. Finally, an exchange rule that permits transactions to be executed using such a combination of procedures must include a specific prohibition against frontrunning between the on- and off-floor markets.[58]

Morgan Stanley, among others, commented that the Commission should clarify the extent to which its relaxation of trading restrictions and, in particular, the relaxation of restrictions on off-floor discussions permitted under proposed section 36.3 is applicable to the execution of positions in non-exempt futures or option contracts which are related to section 4(c) contract market transactions. For example, although, under proposed Rule 36.2(a)(4), an exchange would not be able to trade identical section 4(c) and non-exempt futures or option contracts, traders may seek to trade on spread relationships between exempt and non-exempt 4(c) contracts.

The commenter suggested that the trading rules governing section 4(c) contract market transactions should be applicable in instances where a trading strategy involves both exempt and non-exempt transactions. The Commission disagrees. Where a trading strategy involves transactions executed under both special execution procedures and on-floor competitive procedures, the trader may not rely on its safe harbor for special execution trading procedures to govern both,[59] although other exchange rules which address this situation could be submitted for Commission consideration.

3. Price Transparency

As the Commission stated in proposing section 36.3, transactions under this provision must be transparent.[60] In that regard, paragraph (e)(2) of section 36.3 requires the immediate post-execution report of each purchase and sale transaction executed using special execution procedures by the member specified by exchange rule and the dissemination thereof. The required information includes, at a minimum, price, quantity and contract. The Commission believes that the dissemination of this information is critical for price basing purposes and, therefore, has noted in paragraph (e)(2) of the regulation that special execution transactions may be executed only during hours in which such immediate post-execution dissemination of price basing information is available.[61] The Commission believes that the exchanges should determine how best to structure their proposals so as to assure the integrity of the prices set pursuant to special execution procedures. The Commission wishes to provide the exchanges significant flexibility to address this issue. In addition to other appropriate steps, an exchange could establish a minimum transaction size or could combine special execution procedures and on-floor procedures. The Commission also believes that to fulfill their other self-regulatory obligations, exchanges will have to define monitoring or other surveillance procedures to ensure compliance with these transaction reporting requirements.

4. Clearing

Paragraph (b)(5) of proposed section 36.3 would require that transactions be reported to clearing, and be cleared, on the same schedule as trades subject to Commission Rules 1.38 and 1.39 or otherwise be immediately reported to clearing. The CME commented that the proposal, taken literally, ''would prohibit an exchange from using a Part 36 product as a testing ground to develop faster and more accurate procedures for clearing transactions.'' The Commission believes that this comment has merit and, in paragraph (e)(3) of this regulation, requires the report to clearing, and clearing, of each special execution transaction as quickly as practicable, but in no event later than that required for trades subject to Commission Rules 1.38 and 1.39.[62]

5. Price Reporting for Block Trades

The Commission also requested comment on whether to require the dissemination of separate pricing information for block trades.[63] The FIA commented that ''an exchange submitting a proposed block trading procedure should be afforded the alternatives of including a separate price reporting system or explaining why one is not appropriate or necessary to protect the public interest.'' The CME commented that ''the requirement of a separate ticker for non-standard trades would be both unnecessary and potentially burdensome.'' The Commission has determined that the reporting and dissemination of special execution transactions under existing reporting systems should be satisfactory so long as special execution transactions are clearly identified as such when reported and disseminated and such transactions are executed only during hours when existing reporting systems are available to make immediate post-execution dissemination. Of course, exchanges may choose to operate a separate but comparable ticker for section 4(c) contract market transactions.

6. Prohibition Against Fraud and Manipulation

Paragraph (c) of proposed section 36.3 would require that rules submitted under this section describe the manner in which the rules or procedures would assure compliance with the provisions of sections 4b and 4c(a) of the Act prohibiting false reports, frontrunning, misuse of information, fictitious sales, wash sales, and abuse of customer orders. This paragraph has been replaced by paragraph (e)(4) of section 36.3.[64] This new paragraph requires that rules submitted under this section provide for compliance with section 36.9, which prohibits fraud and manipulation in connection with section 4(c) contract market transactions, except that any trade executed using special execution procedures need not be executed in

[58] Commission staff reviewed frontrunning prohibitions on other markets. *See, e.g.,* NYSE/CME Joint Frontrunning Interpretation (November 27, 1989)(prohibiting trading to take advantage of material non-public information about a trade in the option, stock, or stock index futures markets that can be expected to have a favorable impact on the trading); SEC Release No. 34–27047 (July 19, 1989)(order approving proposed NYSE rule changes that relate to the Joint CME/NYSE Frontrunning Interpretation); NASD Frontrunning Policy (prohibiting trading to take advantage of material non-public information about a trade in the option or stock markets that can be expected to have a favorable impact on the trading); and NASD Schedule G, Section 4(f)(1), Trading Practices (prohibiting members from buying or selling securities while holding unexecuted market or limit orders).

[59] For example, in the case of a spread, the trader could comply with the competitive on-floor trading procedures applicable to the non-exempt portion of the spread for both sides, or the trader could leg into the spread transaction using the particular trading procedures which are available to each side of the spread. In any event, the trader could not rely upon the existence of special execution procedures as the basis for non-compliance with the rules which are applicable to trading traditional designated futures and option contracts.

[60] 59 FR at 54147.

[61] In proposing Rule 36.3, the Commission stated the following: ''To the extent that a proposal for section 4(c) contract market transactions might provide for trading when the exchange floor is closed, the Commission would still require the immediate report and dissemination of that transaction information.'' 59 FR at 54147.

[62] The section 4(c) contract market clearing organization would have an affirmative duty under the Act and Commission Regulations to enforce its rules, and would be subject to recordkeeping, documentation, and other applicable requirements.

[63] As an example, the Commission noted that the NYSE and its vendors maintain a separate ''block trade'' ticker which runs throughout the day and reflects only the size and price of block trades.

[64] With regard to customer orders, paragraphs (c) and (d) of the regulation provide more guidance as to what activity the Commission would consider to be prohibited.

compliance with section 4b(a)(iv) of the Act.

Section 36.9 provides, among other things, that it shall be unlawful to cheat, defraud or deceive or attempt to cheat, defraud or deceive any other person or to willfully make any false report or statement. The Commission believes that compliance with these provisions, when combined with compliance with the other specific customer protection provisions included in section 36.3, should provide for appropriate customer protection safeguards. Rules submitted pursuant to paragraph (c) of section 36.3, which would permit customer order transactions to be executed using special execution procedures, require a specific prohibition against the improper disclosure of customer order information. Rules submitted pursuant to paragraph (d) of Rule 36.3 which would permit transactions to be executed using combined special execution and on-floor competitive procedures, require a specific prohibition against frontrunning. Further, these safeguards apply in a market already limited to specified eligible participants.

In addition, the Commission believes that it is important to provide examples of trading activity that would be permissible and activity that could constitute fraud and customer abuse in violation of section 36.9. It would be permissible to engage in anticipatory hedging. An FCM or floor broker would be allowed to cover when he took the opposite side of a customer order. It would not be permissible for an FCM or floor broker executing transactions using special execution procedures to take the opposite side of a customer order when doing so would deny the fill to another customer. For example, if an FCM or floor broker were to receive matching buy and sell orders from different customers, the FCM or floor broker should not take the opposite side of one of the customer orders if doing so would result in the inability to fill the order of the other customer. It also would continue to be impermissible for an FCM or floor broker to trade ahead of a customer order to the disadvantage of that order.[65]

7. Safe Harbor Provision

Paragraph (f) of section 36.3 enunciates the ''safe harbor'' provisions of the regulation. Transactions in exempt contracts executed in compliance with special execution procedures contained in exchange rules that are permitted to become effective shall not be deemed to be in violation of sections 4b(a)(iv), 4b(b) or 4c(a) of the Act or Commission Rules 1.38(a), 1.39, 155.2, 155.3 and 155.4. Transactions in exempt contracts that are not executed in compliance with such exchange rules shall be deemed to be in violation of section 36.3.

8. Procedures for Permitting Rules to Become Effective

Section 36.3 provides for expedited procedures under which section 4(c) contract market trading rules may be permitted to become effective. Pursuant to paragraphs (g) (1) and (2) of the regulation, section 4(c) contract market trading rules must be submitted to the Commission for review prior to becoming effective. Such rules may become effective ten days after receipt by the Commission unless the Commission, within that ten-day period, notifies the submitter that the proposal does not meet the conditions of this section. Pursuant to paragraph (g)(4) of section 36.3, any subsequent proposed modifications of such rules consistent with this section shall be subject to the same expedited Commission review procedures. In the event that the trading rules, or subsequent modifications thereof, are not permitted to become effective, they shall be subject to the usual rule approval procedures under section 5a(a)(12)(A) of the Act, 7 U.S.C. 7a(12), and Commission Rule 1.41(b).

Paragraph (g)(3) of section 36.3 provides for expedited review of certain large order execution procedures. If a contract market submits for review large order execution procedures for section 4(c) contracts which are substantially similar to procedures approved by the Commission pursuant to Commission Rule 1.39 for non-section 4(c) contracts, then such procedures shall be deemed effective upon Commission receipt thereof.

Proposed exchange clearing and financial integrity rules are not eligible for review under these expedited procedures and, thus, are subject to the usual rule approval procedures under section 5a(a)(12)(A) of the Act, 7 U.S.C. 7a(12), and Commission Rule 1.41(b). In addition, pursuant to paragraph (g)(5), exchanges may submit for Commission review and approval, pursuant to the usual rule approval procedures contained in section 5a(a)(12)(A) of the Act and Rule 1.41(b), other section 4(c) contract market rules which do not conform to the specific trading standards set forth in section 36.3 and which do not satisfy the requirements of the Act and Commission regulations.

D. Listing Procedures

The proposed rules specify a 10-day notification requirement prior to listing new section 4(c) contract market transactions. Most commenters supported the proposed 10-day notification requirement. Several commenters further suggested that a 10-day period should apply to all exchange-traded contracts or to certain categories of such contracts, such as financial futures and options. One commenter stated that the Commission should allow new section 4(c) contract market transactions to become effective, and to begin trading, immediately following the Commission's receipt of notice. This commenter further noted that, if the Commission thereafter determines that trading in a new section 4(c) transaction violates the listing standards in Rule 36.2, the Commission could take appropriate measures, suspending trading without a prior adjudication, pending further review.

The Commission believes that a 10-day advance notification requirement is appropriate. This limited period should allow flexibility in listing new eligible products without impairing exchanges' ability to respond rapidly to market situations. The Commission will evaluate whether the notification period should be eliminated or revised, and whether the 10-day notification provision should be extended to certain non-section 4(c) contract market transactions, when it evaluates trading experience under the pilot program.

[65] With certain exceptions, trading ahead of customer orders recently has been restricted in the OTC securities markets. On May 22, 1995, the SEC issued Securities Exchange Act Release No. 35751 (May 22, 1995), 60 FR 27997 (May 26, 1995), an order approving a proposed rule change submitted by the National Association of Securities Dealers, Inc., (''NASD'') relating to limit order protection on NASDAQ. The rule change amended NASD's interpretation to Article III, Section 1 of the NASD Rules of Fair Practice. The interpretation generally provides that a member firm cannot accept a limit order in a NASDAQ security from its own customer, or from a customer of another member, and continue to trade that security for its own account at prices that would satisfy the customer limit order without filling that order at the limit order price or at a price more favorable to the customer. Limit orders for retail customers that involve 10,000 shares or more and a value of $100,000 or greater are exempt from this prohibition, as are limit orders of any size for institutional accounts. The NASD Rules of Fair Practice define an institutional account as an account of a bank, savings and loan association, insurance company, or registered investment company; a registered investment adviser; or any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million. (''Release 34–35751''). *See also* NYSE Rule 92 (limiting members' trading when they hold an unexecuted customer order); NASD Schedule G, Section 4(f)(1), Trading Practices (prohibiting members from buying or selling securities while holding unexecuted market or limit orders); and CBOE Rule 6.73 (requiring a floor broker to handle an order using due diligence to execute the order at the best price available to him).

E. Reporting

Proposed section 36.5(f)(2) would require traders to provide to the Commission information specified in Commission Rule 18.04 within one business day following receipt of a special call. Commission Rule 18.04 relates to reports regarding a trader's positions and transactions in a particular market as well as identifying, and other, information contained on CFTC Form 40. One commenter questioned whether it is realistic, and necessary, to expect such information to be furnished by a large trader in that time frame. The commenter stated that it would be preferable to rely upon the contract markets and FCMs to provide the data in such a time-sensitive fashion, noting that a federal regulatory requirement for recordkeeping by reportable traders would discourage participation in section 4(c) contract market transactions.

As suggested by the commenter, the Commission normally would rely on clearing member reports in conducting routine oversight of the section 4(c) contract markets. However, the Commission believes that the special call provisions in proposed Rule 36.5(f) are necessary in order to preserve its ability to respond fully and flexibly to concerns it may have regarding potential or developing market congestion, disruptions or other anomalies in section 4(c) contract market transactions. The Commission plans further to review its information needs during the course of the pilot program, but notes that prompt access to large-trader information also has been fundamental to its effective response to market disruptions posed by financial problems at firms holding large concentrations of positions.

F. Risk Disclosure, Temporary Licensing, and Dispute Resolution

1. Risk Disclosure

The Commission proposed, in section 36.7, to permit accounts to be opened for section 4(c) contract market transactions without furnishing an eligible participant with the basic risk disclosure statements applicable generally to non-exempt futures and option contracts under Commission Rules 1.55, 1.65, 33.7 and 190.10,[66] or the Commission's generic risk disclosure statement.[67] In lieu of requiring a specific statement or format, the proviso to proposed section 36.7(a) would require an FCM or, in the case of an introduced account, an IB, to furnish an eligible participant with disclosure appropriate to the particular instrument and the eligible participant prior to the eligible participant's entry into the first section 4(c) contract market transaction involving a particular instrument.[68] Proposed section 36.7(b) makes clear, however, that these provisions do not relieve an FCM or IB from any other disclosure obligation it may have under applicable law.[69]

Several commenters addressed this issue. The CBT stated that proposed section 36.7 leaves to an FCM or IB the flexibility to determine what level of risk disclosure is appropriate for eligible participants, thereby freeing FCMs and IBs from having to provide the CFTC-mandated disclosure forms to new customers, and reducing the competitive advantage foreign firms now enjoy in the risk disclosure area. NYMEX also supported proposed section 36.7 as a sensible approach given the fact that the likely customers of the section 4(c) contract market will be sophisticated entities.

Other commenters, however, expressed concerns about proposed section 36.7. A futures industry association stated that because persons who qualify as eligible participants in section 4(c) contract market transactions are capable of obtaining whatever information they need before engaging in such transactions, a specific requirement to provide disclosure is unnecessary. It also expressed concern, however, that customers would be bombarded with differing disclosure documents that could become the basis of lawsuits or arbitration claims. Others agreed that proposed section 36.7 might create uncertainty, increasing the risk of litigation without decreasing the burden and volume of disclosure. They urged the Commission to follow here an approach similar to Commission Rule 4.7.

The CME recommended that to the extent that any disclosure is required for eligible Part 36 participants, FCMs and IBs be given the choice of using either a specially-prepared disclosure document or the current generic, two-page disclosure statement available for non-exempt products. Morgan Stanley suggested that FCMs and IBs would prefer a safe harbor which required them to furnish the basic risk disclosure statements that are currently generally required, supplemented as specified by the section 4(c) contract market.

The Department of Labor noted that while the proposed Part 36 rules would provide relief from providing certain disclosure requirements to sophisticated investors, pension plan fiduciaries may nonetheless be required by ERISA to request and obtain much of the otherwise required information in order to meet their statutory obligations. The Department further noted that to the extent such information is either unavailable or difficult to obtain, pension plan investment in exempt transactions may be adversely affected.

The Commission has carefully considered these comments and has determined to adopt section 36.7 as proposed. The Commission believes that this rule provides FCMs and IBs with sufficient flexibility concerning risk disclosure with respect to section 4(c) contract market transactions, yet still requires, in accordance with section 4b of the Act, that all material information be disclosed. The Commission believes this approach is consistent with that set forth in Rule 4.7. For those FCMs and IBs seeking guidance in this area, the Commission believes, as a general proposition, that providing the generic risk disclosure statement approved in July 1994, together with any additional risk disclosure developed by the contract market upon which the section 4(c) contracts are traded, as required hereunder for special execution procedures, would be appropriate.[70]

The Commission reiterates, however, that all material information must be disclosed. Thus, the circumstances relating to a particular instrument and customer should be considered by an FCM or IB. For example, to the extent instruments are priced ex-pit, how

[66] The basic risk disclosure statements are intended to provide a brief description of some of the risks attendant to futures and options trading and are designed to be understood by all customers.

[67] 59 FR 34376 (July 5, 1994). This statement currently can be used in the U.S., in the United Kingdom and in Ireland. Several other jurisdictions are considering its adoption.

[68] Because Section 4(c) contract market transactions may be different from traditional futures and option contracts, and are limited to the eligible participants specified in the rule, the Commission expressed its belief in proposing Section 36.7 that it may be preferable to substitute for standard disclosure statements, such disclosure as may be appropriate to the customer's expertise and financial capacity. *See,* 59 FR 54139, 54149–54150.

[69] The Commission explained that this provision was included as a reminder that Section 4b of the Act requires all material information to be disclosed. 59 FR 54139, 54150 & n.47.

[70] The Commission notes a general trend toward the use of generic risk disclosure statements for newer products. For example, the *Framework For Voluntary Oversight* published by the Derivatives Policy Group in March 1995 includes on page 37 thereof a guideline for professional intermediaries on generic risk disclosure which states that ''[a] professional intermediary should consider providing new nonprofessional counterparties with disclosure statements generally identifying the principal risks associated with OTC derivatives transactions and clarifying the nature of the relationship between the professional intermediary and its counterparties.''

prices are obtained may be relevant in certain cases. This requirement does not change existing requirements under sections 4b and 4o of the Act. The Commission particularly notes that the primary relief accorded to customers trading only in section 4(c) contract market transactions is the waiver of the acknowledgment requirement otherwise applicable to non-section 4(c) customers. This relief should materially facilitate access to such transactions, particularly for offshore customers and securities customers who are unaccustomed to acknowledging disclosures. For business or internal control purposes, of course, firms would be free to retain the acknowledgment procedure.

With respect to ERISA concerns, the Commission notes that section 36.7 does not relieve an FCM or IB from any other disclosure obligation it may have under applicable law. Thus, to the extent ERISA requirements pertain to a particular customer, the Commission's rules should not inhibit an FCM or IB from making appropriate disclosures to a pension plan fiduciary. Moreover, in contrast to privately created trading vehicles or instruments, whose specialized characteristics can be meaningfully disclosed only by their creators, information on the mechanics of trading of section 4(c) contract market transactions will be readily available from the listing exchange.

2. Limited Registrations

The Commission proposed section 36.6 to allow special temporary license, registration or principal listing procedures to be available to a person associated with an FCM or IB who limits his or her activities under the Act to section 4(c) contract market transactions. Proposed section 36.6 would require the person to certify that he or she is licensed or otherwise authorized to do business and in good standing with another federal financial regulatory authority or a foreign financial regulatory authority with which the Commission has comparability arrangements under the Part 30 rules, and is not subject to a statutory disqualification from registration under section 8a(2) of the Act. The Commission indicated that a contract market and NFA could develop procedures applicable to these persons that would not require submission of fingerprints and could provide for proficiency testing requirements other than those generally applicable to registrants under the Act.[71]

Several commenters addressed the registration issue. The NFA, which has been delegated a substantial portion of registration functions by the Commission, although commending the Commission's desire to streamline the proficiency testing and fingerprint requirements for persons who limit activities to section 4(c) contract market transactions and recognizing the need for flexibility, expressed the concern that different registration procedures ultimately could be time-consuming, confusing, and administratively cumbersome. The FIA agreed, noting, in addition, that it would be difficult for the industry to develop compliance procedures. The CME reasoned further, that although such special procedures may be useful in the longrun, initially they would be costly to develop and would apply to only a small subset of the industry.

The FIA stated that it was unclear whether the CFTC was conferring on the NFA the ability to waive proficiency testing completely for the individuals involved in the sale of section 4(c) products or merely to establish different tests for different people selling the same product. In its view, requiring registration and full testing for certain individuals involved in selling futures and exempt futures products, yet requiring little or no testing for others, raised issues of fairness and fair competition. The SEC expressed concern that securities training for registered representatives of securities broker-dealers may not be sufficient for purposes of participating in section 4(c) contract market transactions, and stated that the registration requirements should be designed to assure that those licensed have sufficient training to participate in such transactions.

The CBT stated that the Commission should permit the same unregistered sales force as is permitted to vend OTC swaps under Part 35 to market section 4(c) contract market transactions. Alternatively, the CBT urged the Commission to grant limited registration to individuals who intend to sell section 4(c) contract market transactions upon a showing that the individual or his or her employer is in good standing with another federal financial regulatory authority, without requiring Commission registration for the sponsoring employer.

The CBT further commented that proposed section 36.6 should be expanded, in any event, because it applies only to associated persons (''APs'') of an FCM or IB. Employees of non-FCMs or non-IBs, such as securities broker-dealers or banks, would have to be sponsored by entities other than their employers. The CBT stated that this would unduly restrict the potential number of limited registrants able to market section 4(c) contract market transactions and suggested, as a remedy, the creation of a ''limited'' IB registration category for securities broker-dealers or banks in good standing under their respective federal regulatory schemes.[72]

The Commission disagrees with various commenters' recommendation to delete registration requirements for section 4(c) contract market transactions sales persons. Registration is a key element in an effective regulatory and enforcement program. In addition, the Commission believes that fitness checks and a proficiency testing, training or experience requirement are necessary.

However, the Commission has determined to adopt the CBT's alternative suggestion for a ''limited'' IB registration category. Rule 36.6 will allow entities to qualify for limited IB status if they are in good standing with a federal financial regulator or a foreign financial regulator. Banks and securities broker-dealers would be eligible for this special treatment. Insurance companies would not be eligible under Rule 36.6 because of the large number of state insurance regulators and the diverse nature of the applicable regulations. However, the Commission may be willing to entertain proposals developed by contract markets and NFA to permit flexible procedures for insurance company participation in section 4(c) contract market transactions.

As the Commission envisions the process, an entity would provide the NFA with basic identifying information about the firm and its principals and pay the appropriate processing fee. The applicant would also certify that (1) it is in good standing with its other regulator, (2) its principals have filed their fingerprints with the other regulator, (3) neither it nor its principals are subject to statutory disqualification from registration under section 8a(2) of the Act, (4) it will restrict its activities under the Act to section 4(c) contract market transactions, and (5) it will be liable for all acts, omissions and failures, and responsible for the diligent supervision, of its APs, employees and agents in connection with its activities as a limited IB involving section 4(c) contract market transactions.[73]

[71] 59 FR 54139, 54149.

[72] Under this approach, a securities broker-dealer, for example, could qualify as a ''limited IB'' to sponsor its own employees for limited AP registration status under Part 36. The securities broker-dealer would have direct supervisory responsibility over its APs.

[73] Registration, of course, could continue to be denied, conditioned, suspended, restricted or

A firm would not need to submit fingerprints for its principals if it provided similar information to its primary regulator and this information were accessible to the Commission, nor would it be subject to the minimum financial requirements applicable generally to independent IBs provided it met the capital requirements of, and was otherwise in good standing with, its primary regulator. The Commission believes that the limited nature of an IB's activities, its responsibility for its employees and good standing with another financial regulator with such requirements permit waiver of the IB financial requirements.[74]

Customers of a ''limited'' IB, like customers of a regular IB, would be required to transmit funds for trading directly to an FCM, which would carry all customer positions on a fully-disclosed basis.[75] The IB would be required to sponsor its salespersons, who would be subject to a proficiency testing, training or experience requirement, as discussed below. The NFA and the section 4(c) contract markets would determine the specific format of the information to be supplied to the NFA.[76]

As discussed above, certain commenters viewed different registration requirements for each section 4(c) product as potentially administratively unwieldy. Similar concerns were expressed when the Commission adopted Rule 3.12(j), upon which proposed section 36.6 was modeled.[77] Despite the fact that the Commission has permitted section 4(c) contract markets and the NFA, subject to Commission approval, the discretion to vary registration procedures on a contract-by-contract basis, the Commission believes that the special registration procedures ideally would be substantially identical for the various section 4(c) contracts, and that it would be preferable to implement uniform procedures for all such contracts at the outset. As when the Commission adopted Rule 3.12(j), a contract market seeking special registration procedures with respect to persons limiting their activities to section 4(c) contract market transactions may consult and develop the applicable procedures with the NFA and submit them for Commission consideration in conjunction with the other submissions which must be filed under this Part. Of course, if a particular contract market or firm found administration of the alternative procedures too difficult, it could follow the general provisions applicable to any IB or AP.[78]

3. Dispute Resolution

As proposed, all of the provisions of the Act and Commission rules concerning reparations and private rights of action will continue to apply under Part 36. 59 FR at 54144. The CBT commented that section 4(c) contract market transactions should be exempt from Commission Rule 180.3(b)(6), 17 CFR 180.3(b)(6)(1995), which prescribes language that must be included in any pre-dispute arbitration agreement between an FCM and its customers. The prescribed language essentially notifies the customer that, notwithstanding the agreement to arbitrate, the customer can pursue a claim against the FCM through the Commission's reparations forum.

The CBT reasoned that institutional customers do not need this protection, ''either negotiat[ing] such rights or elect[ing] not to sign the pre-dispute arbitration agreement.'' The NYMEX agreed, arguing that the availability of the reparations forum was unnecessary because disputes involving section 4(c) contract market transactions would be ''more than adequately addressed by existing exchange arbitration procedures and comparable NFA procedures.''

The Commission has determined to retain the availability of reparations as a forum for section 4(c) contract market transaction participants as well as the notice provisions of Rule 180.3(b)(6). Although section 4(c) contract market transactions will be entered into by institutional or relatively ''sophisticated'' participants, the reparations program was designed as an inexpensive forum where any customer may seek redress for violations of the Act committed by industry professionals registered with the Commission. The Commission sees no reason to eliminate the availability of this dispute resolution forum.

G. Anti-fraud and Anti-manipulation

The Commission proposed in section 36.9 to apply to section 4(c) contract market transactions the proscriptions against fraud and manipulation found in the Act,[79] and Commission Rules 33.9(d) and 33.10, 17 CFR 33.9(d) and 33.10, which prohibit price manipulation and fraud, respectively, in connection with commodity option transactions. In addition, proposed section 36.9 included a stand-alone prohibition of fraudulent misconduct in connection with section 4(c) contract market transactions.

Commenters expressed varying views on the need for a stand-alone prohibition of fraud in connection with section 4(c) contract market transactions. Some supported including in Part 36 an anti-fraud provision separate and independent from the provisions of the Act and Commission regulations that would, in any event, continue to apply. Others, however,

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revoked under Sections 8a(3) or 8a(4) of the Act, 7 U.S.C. 12a(3) or 12a(4).

[74] Thus, such an IB would not need to raise its own capital or enter into a guarantee agreement with an FCM as generally required for IBs by Commission Rules 1.17(a)(1)(ii) and (a)(2)(ii), respectively. The Commission believes this is consistent with a no-action letter issued on December 1, 1994 by the Division of Trading and Markets, wherein an IB that is a member of various U.K. futures exchanges and a wholly-owned subsidiary of a U.S. FCM was permitted to continue to introduce U.S. contract market transactions based on substituted compliance with U.K. regulatory requirements in lieu of a guarantee agreement under Commission Rule 1.10(j). The Division based its position upon, among other things, the IB's status as a registrant under the Act pursuant to which it is subject to CFTC requirements including, but not limited to, registration, sales practice and other conduct of business rules, recordkeeping, reporting and anti-fraud provisions.

[75] Commission Rule 1.57, 17 CFR 1.57 (1995).

[76] The CBT also stated that the term ''temporary,'' used in proposed Section 36.6 could suggest impermanence or a transition period until a final license would be obtained, and that the term ''limited'' more accurately depicts the registration status of those APs eligible only to market Section 4(c) transactions. The Commission agrees that, in light of its adoption of the provision for limited IBs referred to above, it is also appropriate to refer to APs confining their activities to Section 4(c) contract market transactions as ''limited APs.'' The Commission notes that limited APs may also be eligible for a temporary license during the period that background checks are performed by the NFA.

With respect to testing requirements for limited APs, the NFA could substitute participation in a training module developed by the contract market offering the Section 4(c) transactions or an experience requirement in lieu of the regular, generally applied proficiency test. This is consistent with the Commission's previous approval of NFA Registration Rules 401(b), (c), and (d), permitting persons registered as general securities representatives who restrict their activities under the Act to register as APs without taking the generally required National Commodity Futures Examination (''Series 3 test'') and permitting persons to register if they have passed the regulatory portions of the Series 3 test and the test of a foreign futures authority. The Commission expects that the regulatory portions of the Series 3 test would be included in any modified testing or training module developed for limited APs referred to herein. Further, the Commission will entertain applications to substitute training received in connection with other regulatory requirements, or to recognize specialized ethics training, in satisfaction of the training required under Commission Rule 3.34.

[77] *See* 57 FR 23136, 23141–23142 (June 2, 1992).

[78] Persons following the registration procedures which are generally applicable to transactions under the Act, as well as all of those already registered under the Act, can be involved in the offer and sale of Section 4(c) contract market transactions without being subject to additional registration requirements.

[79] Specifically, proposed Section 36.9 applied to Section 4c contract market transactions Sections 4b and 4*o* of the Act, 7 U.S.C. 6b and 6*o*, and those provisions of Sections 6(c), 6(d), and 9(a) of the Act, 7 U.S.C. 9, 15, 13b and 13(a), that prohibit price manipulation.

asserted that the existing statutory anti-fraud provisions, i.e., sections 4b and 4*o*, would be adequate as applied to section 4(c) contract market transactions, and questioned whether it was appropriate in any event to include a stand-alone anti-fraud provision in Part 36.

In addition, many commenters noted that the text of proposed section 36.9 could be construed as eliminating the scienter requirement which has been held to exist in section 4b of the Act. These commenters observed that the Commission had suggested no policy basis for eliminating scienter as an element of fraud in connection with section 4(c) contract market transactions, thus imposing a lesser standard of proof than applicable for futures transactions in general.

The Commission has concluded that a free-standing anti-fraud rule for section 4(c) contract market transactions is appropriate. Effective prohibition of fraud is a cornerstone of any fair and efficient market. While section 4b of the Act provides an adequate tool to address fraud in traditional futures contract trading, and section 4*o* adequately addresses fraud in connection with commodity pool and trading advisor activities, section 4(c) contract market transactions may involve innovative trading methods and resources that the courts have not addressed previously under the statutory provisions. The Commission is aware of no reason why an additional, comprehensive prohibition of fraud should not apply to section 4(c) contract market transactions across the board. Under the rule as adopted, section 4(c) contract market transactions would be subject to existing prohibitions of fraud and manipulation whenever applicable and the specific prohibitions in Rule 36.9.

However, the Commission agrees with commenters who questioned whether it would be appropriate to have a disparity in scienter requirements applicable to section 4(c) contract market transactions and futures markets in general. Accordingly, section 36.9 as adopted includes the term ''willfully'' in paragraphs (a)(2) and (3), providing a scienter requirement in section 36.9 parallel to that of section 4b.[80] In all other substantive respects, section 36.9 is being adopted as proposed.[81] The Commission notes that actions brought under section 4*o*(1)(B) of the Act, whether involving section 4(c) contract market transactions or other transactions subject to the Commission's jurisdiction, would continue to be governed by existing legal standards, which do not require proof of scienter.[82]

VI. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (''RFA''), 5 U.S.C. 601 *et seq.*, requires that agencies, in proposing rules, consider the impact of those rules on small business. The Commission previously determined that contract markets,[83] futures commission merchants,[84] registered commodity pool operators,[85] and large traders[86] should not be considered ''small entities'' for purposes of the RFA. The Chairman, on behalf of the Commission, previously certified that the proposed rules would not have a significant economic impact on a substantial number of small entities. 59 FR 54151.

In certifying pursuant to section 3(a) of the RFA that the proposed addition to its rules of Part 36—Exemption of section 4(c) Contract Market Transactions would not have a significant economic impact on a substantial number of small entities, the Commission invited comments from any firm which believed that the proposed rules, if adopted, would have a significant economic impact on its activities. No such comments were received.

B. Paperwork Reduction Act

The Paperwork Reduction Act of 1980, (''PRA'') 44 U.S.C. 3501 *et seq.*, imposes certain requirements on federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the PRA. In compliance with the PRA, the Commission previously submitted these rules in proposed form and their associated information collection requirements to the Office of Management and Budget. The Office of Management and Budget approved the collection of information associated with these rules on Jan. 20, 1995, and assigned OMB control number 3038–0047 to the rules. The burden associated with these specific final rules, is as follows:

Average burden hours per response: 2.88
Number of respondents: 300
Frequency of response: on occasion

Copies of the OMB approved information collection package associated with this rule may be obtained from Jeff Hill, Office of Management and Budget, Room 3220, NEOB, Washington, D.C. 20503, (202) 395–7340.

List of Subjects in 17 CFR Part 36

Commodity futures, Commodity options, Prohibited transactions.

In consideration of the foregoing, and pursuant to the authority contained in the Commodity Exchange Act, and in particular, sections 2, 4, 4c, and 8a, 7 U.S.C. 2, 6, 6c, and 12a, as amended, the Commission hereby adds Part 36 to Chapter I of Title 17 of the Code of Federal Regulations as follows:

PART 36—EXEMPTION OF SECTION 4(c) CONTRACT MARKET TRANSACTIONS

Sec.
36.1 Exemption and definitions.
36.2 Trading of section 4(c) contract market transactions.
36.3 Section 4(c) contract market trading rules.
36.4 Listing of section 4(c) contract market transactions.
36.5 Reporting requirements.
36.6 Special procedures relating to registration and listing of principals.
36.7 Risk disclosure.
36.8 Suspension or revocation of section 4(c) contract market transaction exemption.
36.9 Fraud and manipulation in connection with section 4(c) contract market transactions.

Authority: 7 U.S.C. 2, 6, 6c, and 12a.

§ 36.1 Exemption and definitions.

(a) *Duration of Exemption.* The provisions of this Part apply to any section 4(c) contract market transaction entered into on or after November 1, 1995. The provisions of this Part expire, and are no longer valid as to any such transaction entered into on or after three years following the date the first contract trades pursuant to this Part.

(b) *Scope of Exemption.* Each board of trade on which section 4(c) contract market transactions are permitted to be traded pursuant to this Part shall be deemed for such purposes to be designated as a contract market within the meaning of the Act and, with respect to section 4(c) contract market transactions, shall comply with and be subject to all of the provisions of the Act and the Commission's regulations

[80] *See Hammond* v. *Smith Barney, Harris Upham and Co., Inc.*, [1987–1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,617 (CFTC March 1, 1990).

[81] In a related matter, the Commission's proposal requested comment on adopting a stand-alone prohibition of fraud in connection with swap transactions exempt under Part 35 of the Commission's rules. The Commission is not at this time adopting such a provision.

[82] *See Messer* v. *E.F.Hutton & Co.*, 847 F.2d 673, 679 (11th Cir. 1988); *CFTC* v. *Savage*, 611 F.2d 270, 285 (9th Cir. 1979); and *In re Kolter*, [1992–1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶26,262, at 42198 (CFTC Nov. 8, 1994).

[83] 47 FR 18618 (April 30, 1982).

[84] *Id.* at 18619.

[85] *Id.*

[86] *Id.* at 18620.

applicable to a contract market other than those provisions which are specifically inconsistent with this Part, in which case the provisions of this Part shall govern.

(c) Definitions. As used in this Part:

(1) *''Section 4(c) contract market transaction''* means:

Any agreement, contract, or transaction (or class thereof) entered into on or subject to the rules of a contract market in accordance with the provisions of this Part, and that is executed by a member of the section 4(c) contract market that is an eligible participant for its own account, or a futures commission merchant or floor broker for its own account or on behalf of an eligible participant.

(2) *''Eligible Participant''* means:

(i) A bank or trust company;

(ii) A savings association or credit union;

(iii) An insurance company;

(iv) An investment company subject to regulation under the Investment Company Act of 1940 (15 U.S.C. § 80a-1, *et seq.*) or an investment company performing a similar role or function subject as such to foreign regulation, *provided* that such investment company or foreign person is not formed solely for the purpose of constituting an eligible participant and has total assets exceeding $5,000,000;

(v) A commodity pool formed and operated by a person subject to regulation under the Act or a foreign person performing a similar role or function subject as such to foreign regulation, *provided* that such commodity pool or foreign person is not formed solely for the purpose of constituting an eligible participant and has total assets exceeding $5,000,000;

(vi) A corporation, partnership, proprietorship, organization, trust, or other entity not formed solely for the purpose of constituting an eligible participant (A) which has total assets exceeding $10,000,000; or (B) which has a net worth of $1,000,000 and enters into a section 4(c) contract market transaction in connection with the conduct of its business; or (C) which has a net worth of $1,000,000 and enters into a section 4(c) contract market transaction to manage the risk of an asset or liability owned or incurred in the conduct of its business or reasonably likely to be owned or incurred in the conduct of its business;

(vii) An employee benefit plan subject to the Employee Retirement Income Security Act of 1974 or a foreign person performing a similar role or function subject as such to foreign regulation with total assets exceeding $5,000,000 or whose investment decisions are made by a bank, trust company, insurance company, investment adviser subject to regulation under the Investment Advisers Act of 1940 (15 U.S.C. § 80b-1, *et seq.*), or a commodity trading advisor subject to regulation under the Act;

(viii) Any governmental entity (including the United States, any state, or any foreign government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing;

(ix) A broker-dealer subject to regulation under the Securities Exchange Act of 1934 (15 U.S.C. § 78a, *et seq.)* or a foreign person performing a similar role or function subject as such to foreign regulation, acting on its own behalf: *Provided, however,* that if such broker-dealer is a natural person or proprietorship, the broker-dealer must also meet the requirements of paragraph (c)(2)(vi) or (xi) of this section;

(x) A futures commission merchant, floor broker, or floor trader subject to regulation under the Act or a foreign person performing a similar role or function subject as such to foreign regulation; or

(xi) Any natural person with total assets exceeding at least $10,000,000.

(3) *''Section 4(c) contract market trading rules''* means: Contract market rules prescribing trading procedures applicable only to section 4(c) contract market transactions.

(4) *''Terms and conditions''* has the same meaning as in § 1.41(a)(2) of this chapter.

§ 36.2 Trading of section 4(c) contract market transactions.

A section 4(c) contract market transaction may be traded pursuant to the provisions of this Part provided the following conditions are met:

(a) The section 4(c) contract market transaction:

(1) Provides that settlement or delivery shall be in cash (at a cash settlement price that reflects the cash market for the underlying commodity and is based on a price series that is reliable, publicly available, and timely) or by means other than the transfer or receipt of any commodity, except a foreign currency for which there is no legal impediment to delivery and for which there exists a liquid cash market; *provided however,* that the terms and conditions of such transaction are in conformity with the underlying cash market (or, in the absence of conformity, are necessary or appropriate) and that trading is not readily susceptible to price manipulation, nor to causing or being used in the manipulation of the price of any underlying commodity;

(2) Is cleared through a clearing organization subject to Commission oversight;

(3) Except with respect to a broad-based index, does not involve any, or the price of any, wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, millfeed, butter, eggs, onions, solanum tuberousum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, or frozen concentrated orange juice;

(4) Does not involve any commodity futures contract or commodity option contract in which there is any open interest and in which there has been any trading on any board of trade during the six consecutive complete calendar months preceding the date of application to trade as a section 4(c) contract market transaction, unless the transaction can reasonably be distinguished from any such futures contract or commodity option contract based on its hedging function and/or pricing basis; *provided however,* that (i) the five- and ten-year interest rate swaps futures contracts, the Rolling Spot Contracts in foreign currency, and the foreign currency forward futures contracts and options thereon, may be traded as section 4(c) contract market transactions, and (ii) a flexible commodity option may be listed as a section 4(c) contract market transaction prior to listing such option for trading otherwise; and

(5) Does not involve any contracts of sale (or options on such contracts) subject to the provisions of section 2(a)(1)(B) of the Act, including contracts for future delivery of a group or index of securities (or any interest therein or based upon the value thereof).

(b) The contract market on which the section 4(c) contract market transaction is traded need not satisfy the requirements of § 1.61 of this chapter.

(c) The contract market on which the section 4(c) contract market transaction is traded or executed complies with the provisions of this Part.

§ 36.3 Section 4(c) contract market trading rules.

A board of trade may submit for Commission review, pursuant to the expedited procedures set forth in this paragraph, trading rules for section 4(c) contract market transactions (''special execution procedures'') that need not meet the requirements of sections 4b(a)(iv), 4b(b) and 4c(a) of the Act and

§§ 1.38(a), 1.39, 155.2, 155.3 and 155.4 of this chapter, provided that such section 4(c) contract market trading rules satisfy the terms and conditions of this section.

(a) Definition. ''Special execution procedures'' means contract market rules permitting noncompetitive bids, offers, negotiation, and/or execution of orders and transactions.

(b) Special execution procedures that permit a member to trade for his own account opposite the account of another member must provide for an audit trail that meets the requirements of § 1.35(a), (e), (g) and (i) and § 1.38(b) of this chapter.

(c) Special execution procedures that permit a futures commission merchant or floor broker to take the opposite side of a customer order for its own account or permit the execution of orders directly between customer accounts of different principals must provide for an audit trail that meets the requirements of paragraph (b) of this section and that also requires a written record of each customer order which must consist of customer account identification, terms of the order, including price-specific instruction from the customer, order number, and time of order receipt. No order shall be executed without price-specific instruction from the customer. Procedures submitted under this paragraph also must include a specific prohibition against disclosure of customer order information other than to facilitate execution thereof and a requirement that members provide to their customers, in writing, prior to the initial execution for that customer of any transaction using these procedures, a description of the special execution procedures and, in particular, how they vary from on-floor competitive trading procedures.

(d) Section 4(c) contract market trading rules that provide that transactions may be executed using any combination of special execution procedures and competitive on-floor trading procedures must set forth the circumstances under which such transactions could occur competitively on-floor, provided that any transaction executed using special execution procedures be in compliance with paragraphs (b) and (c) of this section, and include a specific prohibition against frontrunning.

(e) Section 4(c) contract market trading rules also must provide for the following:

(1) Record maintenance and retention in accordance with § 1.31 of this chapter;

(2) The immediate post-execution report of each purchase and each sale transaction and dissemination on the relevant market floor, trading screen, and/or vendor service through the board of trade's market quotation system of the price, quantity, and contract traded pursuant to this section. Transactions may be executed pursuant to this section only during hours in which such immediate post-execution dissemination is available;

(3) The report to clearing, and clearing, of each transaction concluded pursuant to this section as quickly as practicable, but in no event later than required for trades subject to §§ 1.38 and 1.39 of this chapter; and

(4) Compliance with § 36.9 of this Part, except that any trade executed using special execution procedures in compliance with this section need not be in compliance with section 4b(a)(iv) of the Act.

(f) (1) Transactions offered or entered into in compliance with special execution procedures submitted to the Commission and permitted to become effective pursuant to the terms of this Part shall not be deemed to violate sections 4b(a) (iv), 4b(b), or 4c(a) of the Act or § § 1.38(a), 1.39, 155.2, 155.3 or 155.4 of this chapter.

(2) No person shall offer or enter into any section 4(c) contract market transaction, unless it meets all requirements of the applicable special execution procedures submitted to the Commission and permitted to become effective pursuant to the terms of this Part.

(g) Submission Procedures

(1) A board of trade seeking review of a section 4(c) contract market trading rule shall furnish one copy of the information set forth in paragraphs (b), (c) or (d) and (e) of this section, as applicable, to the Commission at its Washington, D.C. headquarters. One copy shall also be transmitted by the board of trade to the regional office of the Commission having local jurisdiction over the board of trade. Each submission shall be labeled as being submitted pursuant to this section.

(2) Section 4(c) contract market trading rules submitted by the contract market pursuant to this section shall become effective ten days after receipt of the submission (or such earlier time as may be determined by the Commission or its delegee) unless, within the ten-day period, the Commission or its delegee notifies the board of trade in writing that the submission does not meet the conditions of this section. Upon such notification by the Commission or its delegee, the submission will be subject to the usual procedures for rule approval under section 5a(a)(12)(A) of the Act and § 1.41(b) of this chapter.

(3) Notwithstanding the foregoing, if a contract market submits for review pursuant to this paragraph large order execution procedures that are substantially similar to procedures previously approved by the Commission pursuant to § 1.39 of this chapter for non-section 4(c) contract market transactions, then such procedures shall be deemed effective upon Commission receipt thereof.

(4) Once trading in a section 4(c) contract market transaction has commenced, any modification to any approved section 4(c) contract market trading rule must be submitted to the Commission for review pursuant to the standards and procedures for section 4(c) contract market trading rules set forth in this section.

(5) Other section 4(c) contract market trading rules, which do not conform to the specific trading standards set forth herein and which do not satisfy the requirements of the Act and Commission Rules, may be submitted for Commission approval in accordance with section 5(a)(12)(A) of the Act and § 1.41(b) of this chapter under the usual timeframes.

§ 36.4 Listing of section 4(c) contract market transactions.

(a) A board of trade which has been initially designated as a contract market and has otherwise met the requirements of sections 5 and 5a of the Act (other than section 5a(a)(12)(A)) seeking to permit trading in a section 4(c) contract market transaction shall furnish to the Commission at least ten days prior to its proposed effective date, the rules setting forth the terms and conditions of the proposed section 4(c) contract market transaction.

(b) The board of trade shall furnish one copy of the information set forth in paragraph (a) of this section to the Commission at its Washington, D.C. headquarters. One copy shall also be transmitted by the board of trade to the regional office of the Commission having local jurisdiction over the board of trade. Each submission shall be labeled as being submitted pursuant to this Part.

(c) A board of trade which has been initially designated as a contract market and has otherwise met the requirements of sections 5 and 5a of the Act (other than section 5a(a)(12)(A)) and which meets the requirements of § 36.2 shall be deemed to be designated as a contract market in section 4(c) contract market transactions, the rules submitted shall be deemed to be approved, and section 4(c) contract market transactions may be

traded or executed thereon ten days after receipt of the submission pursuant to this section unless, within the ten-day period, the Commission or its delegee notifies the board of trade in writing that the proposed transactions do not meet the requirements of § 36.2. Upon such notification by the Commission or its delegee, the submission will be subject to the usual procedures for rule approval under section 5a(a)(12)(A) of the Act and § 1.41(b) of this chapter.

(d) Any modification to the rules setting forth the terms and conditions of a section 4(c) contract market transaction shall be submitted to the Commission pursuant to the procedure set forth in this section.

§ 36.5 Reporting requirements.

(a) The reporting requirements set forth in this section shall govern section 4(c) contract market transactions in lieu of the requirements of Parts 16, 17, 18, and 19 of this chapter.

(b) The provisions of § 15.05 and Part 21 of this chapter shall apply to section 4(c) contract market transactions as though they were set forth herein and included specific references to eligible participants.

(c) *Reports by contract markets to the Commission*. Each contract market shall submit to the Commission in accordance with paragraph (d) of this section the following information with respect to section 4(c) contract market transactions by commodity or type of contract as specified by the Commission:

(1) For each commodity or type of contract,

(i) The total gross open contracts at the end of the day covered by the report,

(ii) Total transactions, by type of transaction, as specified by the Commission, which occurred during the day covered by the report, and

(iii) Prices, as specified by the Commission.

(2) For each clearing member by proprietary and customer account,

(i) The total of all long open contracts and the total of all short open contracts carried at the end of the day covered by the report, and

(ii) The quantity of contracts transacted during the day covered by the report, by type of transaction, as specified by the Commission.

(3) *Large trader reports*.

(i) *Reportable positions*. Reportable long and short positions of traders as defined by contract market rules and approved by the Commission, separately for each futures commission merchant or member of the contract market.

(ii) *Identification information*. For each reportable position, the information specified in § 17.01(b)(1)–(b)(8) of this chapter.

(d) *Form and manner of reporting; time and place of filing reports*. Unless otherwise approved by the Commission or its designee, each contract market operating pursuant to this Part shall submit the information required by paragraph (c) of this section as follows:

(1) A format and coding structure approved in writing by the Commission or its designee on compatible data processing media as defined in Part 15 of this chapter shall be used;

(2) The information contained in paragraphs (c)(1) and (c)(2) of this section must be filed daily when the data are first available, but not later than 3:00 p.m. on the business day following the day to which the information pertains. The information contained in paragraph (c)(3) must be filed on call by the Commission or its designee, at such times as specified in the call.

(3) Except for dial-up transmissions, the information should be submitted at the regional office of the Commission having local jurisdiction with respect to such contract market.

(e) *Reports by contract markets to the public*. Each contract market operating pursuant to this Part shall publish for each business day the following information for section 4(c) contract market transactions by commodity or type of contract as specified by the Commission:

(1) The total gross open contracts;

(2) The total number of transactions by transaction type as specified by the Commission; and

(3) Prices, as specified by the Commission.

(f) *Reports and maintenance of books and records by traders*. Every trader who owns, holds, or controls, or has held, owned, or controlled a reportable position, as defined by contract market rules, in contracts traded as section 4(c) contract market transactions shall:

(1) Keep books and records showing all details concerning all positions and transactions with respect to section 4(c) contract market transactions, all positions and transactions in any options traded thereon, and all positions and transactions in the underlying commodity, its products, and by-products and, in addition, commercial activities that the trader hedges in the underlying commodity, and shall upon request furnish to the Commission or the U.S. Department of Justice any pertinent information concerning such positions, transactions, or activities.

(2) File within one business day after a special call upon such trader by the Commission or its designee the following:

(i) Reports showing positions and transactions on such contract markets for the period of time that the trader held or controlled a reportable position, and in a form and manner as instructed in the call; and

(ii) The information specified in § 18.04 of this chapter as though it pertains to section 4(c) contract market transactions.

§ 36.6 Special procedures relating to registration and listing of principals.

(a) Notwithstanding any other provision of law, any person shall be granted a temporary license or registration as a limited introducing broker if such person:

(1) Certifies that it:

(i) Is licensed or otherwise authorized to do business and is in good standing with another federal financial regulatory authority or a foreign financial regulatory authority with which the Commission has comparability arrangements under Part 30 of this chapter and has received Part 30 relief;

(ii) Has filed the fingerprints of its principals with such other regulatory authority;

(iii) And its principals are not subject to a statutory disqualification from registration under section 8a(2) of the Act;

(iv) Will restrict its activities subject to regulation under the Act to section 4(c) contract market transactions; and

(v) Will be liable for all acts, omissions and failures, and responsible for the supervision, of its associated persons, employees and agents in connection with its activities as a limited introducing broker involving section 4(c) contract market transactions; and

(2) Complies with any special temporary licensing or registration procedures applicable to persons whose activities are limited to those specified in paragraph (a)(1)(iv) of this section that have been adopted by the National Futures Association and approved by the Commission.

(3) A person whose activities are limited to those specified in paragraph (a)(1)(iv) of this section shall not be subject to the minimum financial requirements set forth in § 1.17 of this chapter.

(b) Notwithstanding any other provision of law, any person associated with a futures commission merchant, an introducing broker, or a limited introducing broker described in paragraph (a) of this section shall be granted a temporary license or registration to act in the capacity of a limited associated person of such sponsor, or be listed as a principal

thereof, if such person and such person's sponsor:

(1) Certifies that he:

(i) Is licensed or otherwise authorized to do business and in good standing with another federal financial regulatory authority or a foreign financial regulatory authority with which the Commission has comparability arrangements under Part 30 of this chapter and the sponsor, if applicable, has received Part 30 relief;

(ii) Has filed his fingerprints with such other regulatory authority;

(iii) Is not subject to a statutory disqualification from registration under section 8a(2) of the Act; and

(iv) Will restrict his activities subject to regulation under the Act to section 4(c) contract market transactions; and

(2) Complies with any special temporary licensing, registration or principal listing procedures applicable to persons whose activities are limited to those specified in paragraph (b)(1)(iv) of this section that have been adopted by the National Futures Association and approved by the Commission.

§ 36.7 Risk disclosure.

(a) A futures commission merchant or, in the case of an introduced account, an introducing broker, may open an account for a customer with respect to an instrument governed by this Part without furnishing such customer the disclosure statements required under §§ 1.55, 1.65, 33.7, and 190.10 of this chapter: *Provided, however,* that the futures commission merchant or, in the case of an introduced account, the introducing broker, does furnish the customer, prior to the customer's entry into the first section 4(c) contract market transaction with respect to a particular instrument, with disclosure appropriate to the particular instrument and the customer.

(b) This section does not relieve a futures commission merchant or introducing broker from any other disclosure obligation it may have under applicable law.

§ 36.8 Suspension or revocation of section 4(c) contract market transaction exemption.

The Commission may, after notice and opportunity for a hearing, suspend or revoke the exemption of any section 4(c) contract market transaction if the Commission determines that the exemption is no longer consistent with the public interest and the purposes of the Act.

§ 36.9 Fraud and manipulation in connection with section 4(c) contract market transactions.

(a) *Fraud.* The requirements of sections 4b(a) and 4*o* of the Act and § 33.10 of this chapter shall apply to section 4(c) contract market transactions. In any event, it shall be unlawful for any person, directly or indirectly, in or in connection with an offer to enter into, the entry into, the confirmation of the execution of, or the maintenance of any transaction entered into pursuant to this Part—

(1) To cheat or defraud or attempt to cheat or defraud any other person;

(2) Willfully to make or cause to be made to any other person any false report or statement thereof or cause to be entered for any person any false record thereof;

(3) Willfully to deceive or attempt to deceive any other person by any means whatsoever.

(b) *Manipulation.* The requirements of sections 6(c), 6(d), and 9(a) of the Act and § 33.9(d) of this chapter shall apply to section 4(c) contract market transactions.

Issued in Washington, D.C., this 21st day of September, 1995, by the Commission.

Jean A. Webb,

Secretary of the Commission.

[FR Doc. 95–23940 Filed 9–29–95; 8:45 am]

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DEPARTMENT OF LABOR

Employment Standards Administration

20 CFR Parts 702 and 703

RIN 1215–AA92

Longshore and Harbor Workers' Compensation Act and Related Statutes

AGENCY: Employment Standards Administration, Labor.

ACTION: Final rule.

SUMMARY: On May 8, 1995, the Department of Labor published a proposal to amend the regulations implementing the Longshore and Harbor Workers' Compensation Act. The amendments are designed to improve administration and clarify existing policy by: Providing that the district jurisdictional boundaries would be changed by direct notice to affected parties; eliminating the requirement for using certified mail in most circumstances; clarifying that the Office of Workers' Compensation Programs fee schedule would be used to determine the reasonable and customary medical charge where there is a dispute; and modifying the requirement that an employer with geographically different work sites within one compensation district have only one insurance carrier. The final rules are being published essentially unchanged from the proposal.

EFFECTIVE DATE. The rule is effective on November 1, 1995.

FOR FURTHER INFORMATION CONTACT: Joseph Olimpio, Director for Longshore and Harbor Workers' Compensation, Employment Standards Administration, U.S. Department of Labor, Room C–4315, Frances Perkins Building, 200 Constitution Avenue NW., Washington, DC 20210; Telephone (202) 219–8721.

SUPPLEMENTARY INFORMATION:

Introduction

The Longshore and Harbor Workers' Compensation Act (LHWCA; 33 U.S.C. 901, *et seq.*) establishes a federal workers' compensation system for certain workers in covered employment and sets forth the general parameters of the compensation scheme, including the system for filing claims, the benefit levels to be paid, and how the liability of the employer is to be secured. The preamble to the proposed rule published May 8, 1995 (60 FR 22537) sets forth in detail the bases for the changes to the existing rules, which streamline and improve certain administrative functions under the LHWCA.

The authority for the administration of the LHWCA granted to the Secretary of Labor has been delegated to the Office of Workers' Compensation Programs (OWCP). This authority includes initial adjudication of disputed claims, resolution of certain ancillary issues such as disputes involving the amount charged for medical treatment, and responsibility for authorizing private insurance carriers to underwrite coverage. In brief, the changes to the rules affect:

Compensation Districts

The rules will now provide that changes in the administrative compensation districts can be made by notice to all affected parties and not through a change in the regulations. This will ensure that, in this period of rapid change in the way government performs its functions, the program can rapidly reposition its resources as needed.

Certified Mail

The rules remove the requirement that the appropriate office (either the Longshore district office or the Administrative Law Judges (ALJs)) serve via certified mail the notice of deficiency of settlement applications (702.243(b)); Memoranda of the informal conference (702.316); and the notice of