



# Federal Register

---

**Wednesday,  
December 22, 2010**

---

## **Part II**

# **Commodity Futures Trading Commission**

---

**17 CFR Parts 1, 16, and 38  
Core Principles and Other Requirements  
for Designated Contract Markets;  
Proposed Rule**

## COMMODITY FUTURES TRADING COMMISSION

### 17 CFR Parts 1, 16, and 38

RIN 3038-AD09

#### Core Principles and Other Requirements for Designated Contract Markets

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** The Commodity Futures Trading Commission (“Commission” or “CFTC”) is proposing new rules and amended guidance and acceptable practices to implement the new statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). The proposed rules, guidance and acceptable practices, which apply to the designation and operation of contract markets, implement the Dodd-Frank Act’s new statutory framework that, among other things, amends Section 5 of the Commodity Exchange Act (“CEA”) concerning designation and operation of contract markets, and adds a new CEA Section 2(h)(8) to include the listing, trading and execution of swaps on designated contract markets. The Commission requests comment on all aspects of the proposed rules, guidance and acceptable practices.

**DATES:** Comments must be received on or before February 22, 2011.

**ADDRESSES:** You may submit comments, identified by RIN number 3038-AD09, by any of the following methods:

- *Agency Web site, via its Comments Online process:* <http://comments.cftc.gov>. Follow the instructions for submitting comments through the Web site.

- *Mail:* David A. Stawick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.

- *Hand Delivery/Courier:* Same as mail above.

- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments. Please submit your comments using only one method.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to <http://www.cftc.gov>. You should submit only information that you wish to make available publicly. If you wish the Commission to consider information

that you believe is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedures established in § 145.9 of the Commission’s regulations, 17 CFR 145.9.

The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from [www.cftc.gov](http://www.cftc.gov) that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

**FOR FURTHER INFORMATION CONTACT:** Nancy Markowitz, Assistant Deputy Director, 202-418-5453, [nmarkowitz@cftc.gov](mailto:nmarkowitz@cftc.gov), or Nadia Zakir, Attorney-Advisor, 202-418-5720, [nzakir@cftc.gov](mailto:nzakir@cftc.gov), Division of Market Oversight, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.

#### SUPPLEMENTARY INFORMATION:

##### Table of Contents

- I. Background
  - A. Overview
  - B. The Current Statutory Framework
  - C. The Dodd-Frank Act Amendments
- II. The Proposed Rules
  - A. Proposed Repeal of Appendix A to Part 38
  - B. Adoption of New Regulations and Revised Guidance and Acceptable Practices
  - C. Proposed Amendments to General Regulations Under Part 38 (New Subpart A)
    1. Proposed § 38.1—Scope
    2. Proposed § 38.2—Applicable Provisions
    3. Proposed § 38.3—Procedures for Designation
    4. Proposed § 38.4—Procedures for Listing Products and Implementing Designated Contract Market Rules
    5. Proposed § 38.5—Information Relating to Contract Market Compliance
    6. Proposed § 38.7—Prohibited Use of Data Collected for Regulatory Purposes
    7. Proposed § 38.8—Listing of Swaps on a Designated Contract Market
    8. Proposed § 38.9—Designated Contract Markets Operating as Swap Execution Facilities
    9. Proposed § 38.10—Reporting of Swaps Traded on a Designated Contract Market
  - D. Proposed New Regulations and Revised Guidance and Acceptable Practices for Compliance With Core Principles
    1. Subpart B—Designation as Contract Market

2. Subpart C—Compliance With Rules
  - i. Proposed § 38.151—Access Requirements
  - ii. Proposed § 38.152—Abusive Trading Practices Prohibited
  - iii. Proposed § 38.153—Capacity To Detect and Investigate Rule Violations
  - iv. Proposed § 38.154—Regulatory Services Provided by a Third Party
  - v. Proposed § 38.155—Compliance Staff and Resources
  - vi. Proposed § 38.156—Automated Trade Surveillance System
  - vii. Proposed § 38.157—Real-Time Market Monitoring
  - viii. Proposed § 38.158—Investigations and Investigation Reports
  - ix. Proposed § 38.159—Ability To Obtain Information
  - x. Proposed § 38.160—Additional Rules Required
3. Subpart D—Contracts Not Readily Susceptible to Manipulation
4. Subpart E—Prevention of Market Disruption
  - i. Proposed § 38.251—General Requirements
  - ii. Proposed § 38.252—Additional Requirements for Physical Delivery Contracts
  - iii. Proposed § 38.253—Additional Requirements for Cash-Settled Contracts
  - iv. Proposed § 38.254—Ability to Obtain Information
  - v. Proposed § 38.255—Risk Controls for Trading
  - vi. Proposed § 38.256—Trade Reconstruction
  - vii. Proposed § 38.257—Regulatory Service Provider
  - viii. Proposed § 38.258—Additional Rules Required
5. Subpart F—Position Limitations or Accountability
6. Subpart G—Emergency Authority
7. Subpart H—Availability of General Information
  - i. Proposed § 38.401(a)—General
  - ii. Proposed § 38.401(b)—Accuracy Requirement
  - iii. Proposed § 38.401(c)—Notice of Regulatory Submissions
  - iv. Proposed § 38.401(d)—Rulebook
8. Subpart I—Daily Publication of Trading Information
9. Subpart J—Execution of Transactions
  - i. Proposed § 38.501—General Requirements
  - ii. Proposed § 38.502—Minimum Centralized Market Trading Requirement
    - a. Minimum Centralized Market Trading Percentage Requirement
    - b. Centralized Market Trading Percentage Calculation
    - c. Mandatory Delisting
    - d. Treatment of Contracts Listed as of the Effective Date of this Section
    - e. Exemptions
  - iii. Proposed § 38.501—Block Trades on Futures Contracts
  - iv. Proposed § 38.504—Block Trades on Swap Contracts
  - v. Proposed § 38.505—Exchange of Derivatives For Related Positions
  - vi. Proposed § 38.506—Office Trades and Transfer Trades
10. Subpart K—Trade Information

- i. Proposed § 38.551—Audit Trail Required
- ii. Proposed § 38.552—Elements of an Acceptable Audit Trail Program
- iii. Proposed § 38.553—Enforcement of Audit Trail Requirements
- 11. Subpart L—Financial Integrity of Transactions
- 12. Subpart M—Protection of Market Participants
- 13. Subpart N—Disciplinary Procedures
  - i. Proposed § 38.701—Enforcement Staff
  - ii. Proposed § 38.702—Disciplinary Panels
  - iii. Proposed § 38.703—Review of Investigation Report
  - iv. Proposed § 38.704—Notice of Charges
  - v. Proposed § 38.705—Right to Representation
  - vi. Proposed § 38.706—Answer to Charges
  - vii. Proposed § 38.707—Admission or Failure to Deny Charges
  - viii. Proposed § 38.708—Denial of Charges and Right to Hearing
  - ix. Proposed § 38.709—Settlement Offers
  - x. Proposed § 38.710—Hearings
  - xi. Proposed § 38.711—Decisions
  - xii. Proposed § 38.712—Right to Appeal
  - xiii. Proposed § 38.13—Final Decisions
  - xiv. Proposed § 38.714—Disciplinary Sanctions
  - xv. Proposed § 38.715—Summary of Fines for Violations of Rules Regarding Timely Submission of Records, Decorum or Other Similar Activities
  - xvi. Proposed § 38.716—Emergency Disciplinary Actions
- 14. Subpart O—Dispute Resolution
- 15. Subpart P—Governance Fitness Standards
- 16. Subpart Q—Conflicts of Interest
- 17. Subpart R—Composition of Governing Boards of Contract Markets
- 18. Subpart S—Recordkeeping
- 19. Subpart T—Antitrust Considerations
- 20. Subpart U—System Safeguards
- 21. Subpart V—Financial Resources
  - i. Proposed § 38.1101(a)—General Requirements
  - ii. Proposed § 38.1101(b)—Types of Financial Resources
  - iii. Proposed § 38.1101(c)—Computation of Financial Resource Requirement
  - iv. Proposed § 38.1101(d)—Valuation of Financial Resources
  - v. Proposed § 38.1101(e)—Liquidity of Financial Resources
  - vi. Proposed § 38.1101(f)—Reporting Requirements
- 22. Subpart W—Diversity of Boards of Directors
- 23. Subpart X—Securities and Exchange Commission
- III. Related Matters
  - A. Regulatory Flexibility Act
  - B. Paperwork Reduction Act
    - 1. Additional Information Provided by Designated Contract Markets
    - 2. Information Collection Comments
  - C. Cost Benefit Analysis
- IV. Text of Proposed Rules

## I. Background

### A. Overview

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street

Reform and Consumer Protection Act<sup>1</sup> Title VII of the Dodd-Frank Act<sup>2</sup> amended the CEA<sup>3</sup> to establish a comprehensive, new regulatory framework for swaps and security-based swaps. The legislation was enacted to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: (1) Providing for the registration and comprehensive regulation of swap dealers and major swap participants; (2) imposing clearing and trade execution requirements on standardized derivative products; (3) creating robust recordkeeping and real-time reporting regimes; and (4) enhancing the Commission's rulemaking and enforcement authorities with respect to, among others, all registered entities and intermediaries subject to the Commission's oversight.

Section 735 of the Dodd-Frank Act amended Section 5 of the CEA pertaining to the designation and operation of contract markets, by: (i) Eliminating the stand-alone designation criteria contained in former Section 5(b) of the CEA; (ii) revising the existing core principles, including incorporating therein most of the substantive elements of the former designation criteria; and (iii) adding five new core principles, thereby requiring applicants and designated contract markets ("DCMs") to comply with a total of 23 core principles as a condition of obtaining and maintaining designation as a contract market.

In addition, Section 723(a)(3) of the Dodd-Frank Act added Section 2(h)(8) of the CEA to require, among other things, that execution of swaps subject to the clearing requirement of Section 2(h)(1) of the CEA must occur either on a DCM or on a new type of regulated facility called a Swap Execution Facility ("SEF").<sup>4</sup> Also, Section 733 of the Dodd-Frank Act added Section 5h(a)(1), requiring that no person may operate a facility for the trading or processing of swaps unless the facility is registered as

a SEF or as a DCM. Accordingly, the rules proposed in this release also implement provisions related to the processing, trading and execution of swaps on DCMs.

In enacting the Dodd-Frank Act, Congress directed that rules and regulations required by the provisions of Title VII take effect the later of 360 days after enactment of the bill or to the extent that a rulemaking is required by the Dodd-Frank Act, not less than 60 days after the publication of that final rule.<sup>5</sup> Consistent with Congress' directive, this release proposes amendments to parts 38, 16 and 1 of the Commission's regulations to implement Section 5 of the CEA, as well as the requirements of Sections 2(h)(8) and 5h(a)(1) of the CEA, as amended by the Dodd-Frank Act, as applicable to DCMs.

### B. The Current Statutory Framework

Section 5 of the CEA governs the designation and operation of DCMs.<sup>6</sup> DCMs were first established under the Commodity Futures Modernization Act of 2000 ("CFMA")<sup>7</sup> as one of two forms of Commission-regulated markets for the trading of contracts for sale of a commodity for future delivery or commodity options.<sup>8</sup>

The CEA, as amended by the CFMA, requires a DCM applicant to demonstrate that it satisfies each of

<sup>5</sup> See Section 754 of the Dodd-Frank Act.

<sup>6</sup> 7 U.S.C. 7; see also, Section 5 of the CEA, as amended by the Dodd-Frank Act.

<sup>7</sup> Commodity Futures Modernization Act of 2000, Public Law 106-554, 114 Stat. 2763 (2000) ("CFMA").

<sup>8</sup> The CFMA established two tiers of regulated markets—designated contract markets and registered derivatives transaction execution facilities ("DTEFs"). In addition, the CFMA provided for two markets exempt from regulation, exempt boards of trade ("EBOTs") and exempt commercial markets ("ECMs"). A description of the categories, requirements and functions of each of these markets as first established under the CFMA is provided in the Commission's notice of proposed rulemaking and final rulemaking implementing the CFMA. See *A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations*, Notice of Proposed Rulemaking, 66 FR 14,262, March 9, 2001; Final Rulemaking, 66 FR 42,256, Aug. 10, 2001. In addition, a new type of regulated market was created under the CFTC Reauthorization Act of 2008 ("Farm Bill"), incorporated as Title XIII of the Food, Conservation and Energy Act of 2008, Public Law 110-246, 122 Stat. 1651 (June 18, 2008). Under the Farm Bill, the Commission was required to determine and make public its determination whether a particular agreement, contract or transaction executed or traded on an ECM serves a significant price discovery function ("SPDC"). Once a contract was identified as a SPDC, the ECM on which the contract was traded was required to demonstrate to the Commission that the ECM had a regulatory system in place that satisfied the requirements of the core principles under current Section 2(h)(7) of the current CEA and the applicable provisions of § 36.3 of the Commission's regulations. Section 723 of the Dodd-Frank Act repealed the ECM SPDC provisions.

<sup>1</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act"). The text of the Dodd-Frank Act may be accessed at [http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/hr4173\\_enrolledbill.pdf](http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/hr4173_enrolledbill.pdf).

<sup>2</sup> Pursuant to Section 701 of the Dodd-Frank Act, Title VII may be cited as the "Wall Street Transparency and Accountability Act of 2010."

<sup>3</sup> 7 U.S.C. 1 *et seq.* (amended 2010).

<sup>4</sup> The Commission will be proposing rules governing the registration and operation of SEFs in a separate, forthcoming rulemaking. See CFTC Web site for additional information on the "SEF Registration Requirements and Core Principle Rulemaking, Interpretation & Guidance" rulemaking, at [http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF\\_13\\_SEFRules/index.htm](http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_13_SEFRules/index.htm) (last visited Dec. 14, 2010).

eight designation criteria as a condition of obtaining designation as a contract market.<sup>9</sup> In addition, each applicant is required to demonstrate its ability to comply with 18 core principles at the time of application, and on an ongoing basis after designation.<sup>10</sup>

### C. The Dodd-Frank Act Amendments Applicable to Designated Contract Markets

Section 735 of the Dodd-Frank Act amends Section 5 of the CEA by: (i) Eliminating the eight criteria for designation as a contract market; (ii) amending many of the core principles, including incorporating most of the substantive requirements of the current designation criteria, and requiring that all DCMs demonstrate compliance with each of the core principles as a condition of obtaining and maintaining designation as a contract market; and (iii) adding five new core principles, specifically Core Principle 13 (Disciplinary Procedures), Core Principle 20 (System Safeguards), Core Principle 21 (Financial Resources), Core Principle 22 (Diversity of Boards of Directors), and Core Principle 23 (Securities and Exchange Commission).<sup>11</sup>

As noted above, the Dodd-Frank Act also specifically requires under Section 2(h)(8) of the CEA, as amended,<sup>12</sup> that execution of swaps that are required to be cleared must occur on either a DCM or a SEF, except where no DCM or SEF makes the swap available for trading.<sup>13</sup> Accordingly, unless otherwise specified in this release, each of the 23 core principles and the proposed regulations, guidance and acceptable practices, apply to all “contracts” listed on a DCM, which will include swaps, futures and options contracts.

In sum, the new and revised regulations, guidance and acceptable practices proposed in this release will implement the regulatory obligations

that each DCM must meet in order to comply with Section 5 of the CEA, as amended by the Dodd-Frank Act, initially upon designation and thereafter on an ongoing basis. The Commission requests comments on all aspects of the proposed rules, guidance and acceptable practices.

## II. The Proposed Rules

### A. Proposed Repeal of Appendix A to Part 38

Section 735 of the Dodd-Frank Act eliminates the criteria for designation as a contract market in current CEA Section 5(b), creates a new core principle from one of the criterion, and incorporates most of the substance of the remaining designation criteria into the core principles. Because the designation criteria are eliminated under the Dodd-Frank Act, the Commission proposes to eliminate the guidance on compliance with the designation criteria for DCMs contained in Appendix A to part 38. As noted below, this release further proposes to redesignate Appendix A as the application form for contract market designation.

### B. Adoption of New Regulations and Revised Guidance and Acceptable Practices

In implementing the provisions of the CFMA, the Commission adopted a regulatory framework for part 38 of its regulations that consisted largely of general application guidance and acceptable practices consistent with the CFMA’s principles-based regime.<sup>14</sup> The Dodd-Frank Act amends Section 5(d)(1)(B) of the CEA generally to provide that the Commission, in its discretion, may determine by rule or regulation the manner in which boards of trade comply with the core principles.<sup>15</sup> Accordingly, the

Commission undertook a comprehensive evaluation of its existing regulations, guidance and acceptable practices associated with each of the core principles in order to update those provisions and to determine which core principles would benefit from new or revised regulations and new or revised guidance or acceptable practices. Based on that review, the Commission is proposing both new and revised regulations and revised guidance and acceptable practices for some core principles, as set forth in this release.

The proposed new regulations codify certain requirements and practices that are commonly accepted in the industry and have been found, based on the Commission’s administrative experience in overseeing the futures markets since passage of the CFMA, to represent the best practice means of complying with the core principles.<sup>16</sup> Indeed, some of these requirements are the off-shoot of the Rule Enforcement Reviews (“RERs”) periodically carried out by Commission staff.

The RERs are the cornerstone of the Commission’s oversight program, serving as a key tool for monitoring a DCM’s compliance with the core principles, and also as a primary means for identifying industry trends and DCM best practices for self-regulation. Essentially, RER findings and recommendations communicate to the industry what Commission staff believes are best practices for compliance and such recommendations typically are then adopted industry-wide as the standard form of compliance.

The RERs, which are conducted periodically at all DCMs, typically examine DCMs’ compliance with specific core principles relating to audit trail, trade practice surveillance, market surveillance, disciplinary programs, and dispute resolution.<sup>17</sup> Commission staff’s

<sup>9</sup> The eight designation criteria under current Section 5(b) of the CEA are titled the following: (1) In General; (2) Prevention of Market Manipulation; (3) Fair and Equitable Trading; (4) Trade Execution Facility; (5) Financial Integrity of Transactions; (6) Disciplinary Procedures; (7) Public Access; and (8) Ability to Obtain Information.

<sup>10</sup> 7 U.S.C. 7(d). The Commission also undertakes due diligence reviews of each contract market’s compliance with the core principles during rule and product certification reviews and periodic examinations of DCMs’ compliance with the core principles under Rule Enforcement Reviews (“RERs”).

<sup>11</sup> New Core Principle 13 is verbatim of current Designation Criterion 6.

<sup>12</sup> See Section 723 of the Dodd-Frank Act.

<sup>13</sup> Section 5h(a)(1) of the CEA, as amended by Dodd-Frank Act, also prohibits any person from operating a facility for the trading and processing of swaps unless the facility is registered as a SEF or DCM.

<sup>14</sup> Guidance provides DCMs and DCM applicants with contextual information regarding the core principles, including important concerns which the Commission believes must be taken into account in complying with specific core principles. In contrast, the acceptable practices are more specific than guidance and provide examples of how DCMs may satisfy particular requirements of the core principles; they do not, however, establish mandatory means of compliance. Acceptable practices are intended to assist DCMs by establishing non-exclusive safe harbors. The safe harbors apply only to compliance with specific aspects of the core principle, and do not protect the contract market with respect to charges of violations of other sections of the CEA or other aspects of the core principle.

<sup>15</sup> Current Core Principle 1 states, among other things, that boards of trade “shall have reasonable discretion in establishing the manner in which they comply with the core principles.” This “reasonable discretion” provision underpins the Commission’s use of core principle guidance and acceptable practices. Section 735 of the Dodd-Frank Act

amends this provision to include the proviso that “[u]nless otherwise determined by the Commission by rule or regulation \* \* \*,” boards of trade shall have reasonable discretion in establishing the manner in which they comply with the core principles. See Section 735(b) of the Dodd-Frank Act, amending Section 5(d)(1)(B) of the CEA.

<sup>16</sup> The Commission’s oversight of DCMs’ compliance with the core principles includes the evaluation of applications for contract market designation, periodic RERs of DCMs’ compliance with various statutory requirements, and the review of rule and product certifications implicating all aspects of the core principles.

<sup>17</sup> Staff typically review a one-year target period and, depending on the core principles covered, thoroughly examine a DCM’s audit trail reviews, trade practice and market surveillance investigations, investigation logs, hedge exemptions, surveillance systems, compliance manuals, summary fine schedules, disciplinary files, settlement agreements, and arbitration files. Staff also conducts on-the-record interviews with DCM compliance officials.

findings and any recommendations for improvement are included in a report that is presented to the Commission, and the Commission votes on whether to accept the report. The RER report is publicly released and published on the Commission's Web site and also sent to the DCM. Although a DCM may not fully agree with the Commission staff's findings, responses from DCMs, which are required within 30 days, almost always explain how the DCM intends to implement staff's recommendations, if any. Because RER reports are public, recommendations for one DCM invariably lead to all DCMs that suffer from the same identified shortfall taking timely corrective action. Such corrective action usually includes modifying compliance procedures and/or adopting or modifying existing rules.

The Commission believes that the promulgation of clear-cut and definite requirements or practices in those instances where a standard industry practice has developed would provide greater legal certainty to the industry in demonstrating compliance with the CEA. Accordingly, in certain circumstances, the Commission is proposing to replace the general application guidance and acceptable practices in part 38 with regulations that codify the relevant practices and requirements for those core principles. For some of the new core principles, the Commission also is proposing regulations that represent the best practice for complying with the core principle. For several core principles, the Commission is proposing to maintain the guidance and acceptable practices, albeit with proposed revisions that reflect developments in the industry since the passage of the CFMA, and the Commission's considerable experience since the passage of the CFMA with matters involving compliance with the core principles by a broad range of DCMs.

### *C. Proposed Amendments to General Regulations Under Part 38 (New Subpart A)*

The Commission is proposing to reorganize part 38 to include new subparts A through X. Proposed subpart A would include the general regulation §§ 38.1 through 38.10,<sup>18</sup> applicable both to DCM applicants and to existing DCMs. Subparts B through X would each include relevant regulations applicable to each core principle.<sup>19</sup>

<sup>18</sup> This release does not propose any revisions to § 38.6 of the Commission's regulations.

<sup>19</sup> Each of these subparts begins with a regulation containing the language of the core principle.

#### 1. Proposed § 38.1—Scope

The proposed revisions to § 38.1 are non-substantive as they simply eliminate cross-references to other sections of the Commission's regulations that are no longer applicable, and add references to sections, most of them new, that are now applicable.

#### 2. Proposed § 38.2—Applicable Provisions

Section 38.2 sets forth the Commission regulations that DCMs must comply with in addition to those in part 38. The proposed revisions to § 38.2 include a change to the title of the section to more accurately describe the regulation, and further updates the list of Commission regulations that are applicable to DCMs based on the new provisions under the Dodd-Frank Act, including the proposed provisions relating to real time reporting of swaps and the determination of appropriate block size for swaps which will be proposed under part 43, requirements for data element, recordkeeping and reporting of swap information to swap data repositories which will be proposed under part 45, business continuity and disaster recovery which will be proposed under part 46, designation requirements for swap data repositories which will be proposed under part 49, and position limits which will be proposed under part 151.<sup>20</sup>

#### 3. Proposed § 38.3—Procedures for Designation

Current § 38.3 sets forth the application and approval procedures for new DCM applications.<sup>21</sup> The Commission is proposing in § 38.3 that all DCM applications, reinstatements, requests for transfer of designations, requests for withdrawal of application for designation, and vacation of designations be filed with the Secretary of the Commission in an electronic format, via the Internet, e-mail, or other means of direct electronic submission as approved by the Commission.<sup>22</sup>

The Commission also is proposing to eliminate the expedited approval procedures for DCM applications, such

<sup>20</sup> The Commission notes that because some of the proposed rulemakings are either ongoing or forthcoming, this proposed list of reserved sections under § 38.2 may be subject to further revisions pending the final rules for each respective rulemaking.

<sup>21</sup> In addition to these substantive revisions, many of the proposed revisions to § 38.3 are non-substantive and are intended to clarify the rule.

<sup>22</sup> This amendment also would ensure consistency with the electronic process used for filing rule and product submissions under parts 39 and 40 of the Commission's regulations. See 17 CFR parts 39 and 40.

that the timing of such reviews will be governed only by the 180-day statutory review period and procedures specified in Section 6(a) of the CEA.<sup>23</sup> Based upon its experience since 2001, the Commission has determined that the 90-day accelerated review process is inefficient and impracticable. Specifically, the Commission has found that applicants seeking expedited review often file incomplete or draft applications, without adequate supporting materials, in the interest of meeting the expedited approval timeline. This, in turn, has required Commission staff to expend significant amounts of time reviewing incomplete or draft applications, necessitating numerous follow-up conversations with applicants, usually resulting in removal of applications from the expedited review timeline. The Commission believes that by requiring all applications to be reviewed within the 180-day review period, applicants will have sufficient time to submit complete applications for review, and to respond to Commission staff requests for additional information, resulting in a more efficient review process.<sup>24</sup>

To provide an applicant with more certainty of the types of information that are required to support its DCM application, the Commission proposes to redesignate Appendix A to part 38<sup>25</sup> to include a new application form with comprehensive instructions to guide DCM applicants and a specified lists of documents and information that must be provided as exhibits.<sup>26</sup> Other than the specific requirements necessitated by the revised and newly added core principles, the majority of information required under the form application consists of information that historically has been required by the Commission staff in its reviews of DCM applications under the Commission's regulations. Accordingly, proposed § 38.3(a)(1) requires that, at a minimum, all applicants must complete the application form and provide the necessary information and documentation, in accordance with the associated instructions, in order to

<sup>23</sup> 7 U.S.C. 8(a); see also, Section 6(a) of the CEA, as amended by the Dodd-Frank Act.

<sup>24</sup> This proposal also is consistent with the Commission's proposal to eliminate the 90-day expedited review procedures for derivatives clearing organization applications under part 39 in a separate rulemaking.

<sup>25</sup> Appendix A currently contains the stand alone designation criteria now eliminated under the Dodd-Frank Act.

<sup>26</sup> The Commission also is requiring tailored application forms for the registration of Designated Clearing Organizations, Swap Execution Facilities and Swap Data Repositories.

initiate the 180-day designation review process.

The Commission is proposing new § 38.3(d) to formalize the procedures that a DCM must follow when requesting the transfer of its DCM designation and positions comprising open interest, in anticipation of a corporate event (*e.g.*, a merger, corporate reorganization, or change in corporate domicile) which results in the transfer of all or substantially all of the DCM's assets to another legal entity. Under proposed § 38.3(d)(2), the DCM would submit to the Commission a request for transfer no later than three months prior to the anticipated corporate change, with a limited exception.<sup>27</sup> The request shall include: (1) The underlying agreement that governs the corporate change; (2) a narrative description of the corporate change, including the reason for the change and its impact on the DCM, including its governance and operations, and its impact on the rights and obligations of market participants holding the open positions; (3) a discussion of the transferee's ability to comply with the CEA, including the core principles applicable to DCMs, and the Commission's regulations thereunder; (4) the governing documents of the transferee, including but not limited to, articles of incorporation, bylaws, operating agreements and/or partnership agreements, as applicable; (5) the transferee's rules marked to show changes from the current rules of the DCM; and (6) a list of contracts, agreements, transactions or swaps for which the DCM requests transfer of open interest.

Proposed § 38.3(d) also would require, as a condition of approval, that the DCM submit a representation that it is in compliance with the CEA, including the DCM core principles, and the Commission's regulations. In addition, the DCM would have to submit various representations by the transferee, including but not limited to: (1) That the transferee will assume responsibility for complying with all applicable provisions of the CEA and the Commission's regulations promulgated thereunder, including part 38 and Appendices thereto; (2) that the transferee will assume, maintain and enforce all rules implementing and complying with these core principles, including the adoption of the transferor's rulebook; (3) upon the transfer, all open interest in all contracts

listed on the transferor will be transferred to and represent equivalent open interest in all such contracts listed on the transferee, (4) that none of the proposed rule changes will affect the rights and obligations of any participant with open positions transferred to it; and (5) it will notify market participants of any changes to the rulebook and of the transfer.

Proposed § 38.3(d) also provides that the Commission will review any requests for transfer of designation and open interest as soon as practicable, and such request will be approved or denied pursuant to a Commission order.

Proposed § 38.3(g)<sup>28</sup> is a new rule that is intended to ensure that all DCMs designated before the effective date of the rules proposed in this part 38 are in compliance with both the five new core principles and the revised core principles. As noted above, the Dodd-Frank Act significantly changes some of the compliance obligations of DCMs under current Section 5 of the CEA by amending the majority of the existing core principles and adding five new core principles.<sup>29</sup> All DCMs, including existing DCMs, must comply with the requirements of Section 5 of the CEA, as amended, as well as the applicable requirements under the Commission's regulations, including this release, upon their effective date. Accordingly, in proposed § 38.3(g), the Commission would require that each existing DCM provide the Commission with a signed certification of its compliance with each of the 23 core principles and the Commission's regulations under part 38 as amended in this release, within 60 days of the effective date of the publication of the final rules proposed in this release. The failure of any existing DCM to provide such certification shall be grounds for revocation of the DCM's designation status. While the Commission believes that 60 days is a sufficient period of time for DCMs to have rules and procedures in place to ensure compliance with the core principles and the rules proposed in this release, the Commission requests comments on whether the 60 day period is sufficient, and if not, what period of time may be more appropriate and why.

#### 4. Proposed § 38.4—Procedures for Listing Products and Implementing Designated Contract Market Rules

The proposed amendments to § 38.4 are largely intended to conform this rule

to the proposed changes to existing §§ 40.3 (Voluntary submission of new products for Commission review and approval) and 40.5(b) (Voluntary submission of rules for Commission review and approval).<sup>30</sup> The proposed amendments to those rules are made in the separate release pertaining to "Provisions Common to Registered Entities."<sup>31</sup>

#### 5. Proposed § 38.5—Information Relating to Contract Market Compliance

On occasion, DCMs enter into equity interest transfers that result in a change in ownership. In those situations, Commission staff must determine whether the change in ownership will impact adversely the operations of the DCM or the DCM's ability to comply with the core principles and the Commission's regulations. The Commission is proposing to amend § 38.5 to ensure that DCMs remain mindful of their self-regulatory responsibilities when negotiating the terms of significant equity interest transfers, and to improve the Commission staff's ability to undertake a timely and effective due diligence review of the impact, if any, of such transfers.

In this regard, proposed § 38.5(c) would require DCMs to file with the Commission a notice of the equity interest transfer of ten percent or more, no later than the business day, as defined in § 40.1, following the date on which the DCM enters into a firm obligation to transfer the equity interest.<sup>32</sup> The notification must include and be accompanied by: (i) Any relevant agreement(s), including preliminary agreements; (ii) any associated changes to relevant corporate documents; (iii) a chart outlining any new ownership or corporate or organizational structure;

<sup>30</sup> Proposed § 40.3 is amended to require additional information to be provided by registered entities submitting new products for the Commission's review and approval. Proposed § 40.5(b) codifies a new standard for the review of new rules or rule amendments as established under the Dodd-Frank Act.

<sup>31</sup> 75 FR 67482, Nov. 2, 2010.

<sup>32</sup> The Commission is proposing a 10 percent threshold because it believes that a change in ownership of such magnitude may have an impact on the operations of the DCM. The Commission believes that such impact may be present even if the change in ownership does not constitute a change in control. For example, if one entity holds a minority 10 percent equity share in the DCM, it may have a more significant voice in the operation of the DCM than five entities each with a minority 2 percent equity share. Given the potential impact that a change in ownership might have on the operations of a DCM, the Commission believes that it is appropriate to require such DCM to certify after such change that it continues to comply with all obligations under the CEA and Commission regulations.

<sup>27</sup> The proposed rule would require that where a DCM does not know or could not have reasonably known three months prior to the anticipated change, it shall be required to file the request as soon as it knows of the change.

<sup>28</sup> In addition, proposed §§ 38.3(e) and 38.3(f) restate existing requirements with certain non-substantive, clarifying changes.

<sup>29</sup> Compare 7 U.S.C. 7(d) with section 5(d) of the CEA, as amended by the Dodd-Frank Act.

(iv) a brief description of the purpose and any impact of the equity interest transfer; and (v) a representation from the DCM that it meets all of the requirements of Section 5(d) of the Act and Commission regulations adopted thereunder. The proposed rule requires that the DCM keep the Commission apprised of the projected date that the transaction resulting in the equity interest transfer will be consummated, and must provide to the Commission any new agreements or modifications to the original agreement(s) filed pursuant to § 38.5(c). The DCM must notify the Commission of the consummation of the transaction on the day in which it occurs. The proposed rule will enable staff to consider whether any conditions contained in an equity transfer agreement(s) are inconsistent with the self-regulatory responsibilities of a DCM or with any of the core principles.<sup>33</sup>

Section 38.5(d) currently requires that upon a change in ownership, an acquirer of an existing DCM must certify that the exchange meets all of the requirements of the current Sections 5(b) and 5(d) of the Act, and the provisions of part 38 of the Commission's regulations. The Commission believes when there is a 10% or greater change in ownership, the DCM itself is the more appropriate entity to provide a certification of its continued compliance with all regulatory obligations. Accordingly, proposed § 38.5(c)(3)<sup>34</sup> would require that if there is a change in ownership<sup>35</sup> the DCM must certify, no later than two business days following the date on which the change in ownership occurs, that the DCM meets all of the requirements of Section 5(d) of the CEA, as amended by the Dodd-Frank Act, and the provisions of part 38 of the Commission's regulations. The proposed rule also requires that the DCM include as part of its certification whether any aspects of the DCM's operations will change as a result of the change in ownership, and if so, the DCM must provide a description of the changes. Finally, proposed § 38.5(c) provides that the certification may rely

<sup>33</sup> The Commission also maintains the existing provisions of § 38.5 that allow the Commission at any time to request a DCM to file a written demonstration with the Commission that it is in compliance with one or more of the core principles.

<sup>34</sup> The Commission is proposing to redesignate § 38.5(d) as § 38.5(c).

<sup>35</sup> The Commission's regulations consistently identify a financial or ownership interest of ten percent or more as material and indicative of the ability to influence the activities of an entity or trading in an account. *See, e.g.*, Core Principle 5, Acceptable Practices, and Core Principle 14, Application Guidance, in appendix B to part 38 of the Commission's regulations. 17 CFR part 38, appendix B.

on, and be supported by, prior materials and information submitted as part of an application for designation or a required product or rule filing or new filings if necessary to update its previous filings.

#### 6. Proposed § 38.7<sup>36</sup>—Prohibited Use of Data Collected for Regulatory Purposes

To fulfill their regulatory and compliance obligations, DCMs often require market participants to provide proprietary data or personal information. Proposed § 38.7 would prohibit DCMs from using such information for business or marketing purposes.<sup>37</sup> The Commission notes that nothing in this provision should be viewed as prohibiting a DCM from sharing such information with another DCM or SEF for regulatory purposes, where necessary.

#### 7. Proposed § 38.8—Listing of Swaps on a Designated Contract Market

The Dodd-Frank Act permits existing DCMs to list, trade and execute swaps, provided that the DCMs do so in a manner that complies with the provisions of the CEA, as amended by the Dodd-Frank Act, and part 38, as amended. Proposed § 38.8(a) requires a DCM to notify the Commission, prior to or upon listing its first swap contract, of the manner in which it will fulfill each of the requirements under amended CEA and part 38 with respect to the listing, trading, execution and reporting of swap transactions.

Proposed § 38.8(b) requires a DCM to request and obtain from the Commission a unique, extensible, alphanumeric code for the purpose of identifying the DCM before it lists swaps. A DCM will do so pursuant to the swap recordkeeping and reporting requirements under proposed part 45 of the Commission's regulations. This requirement stems from the Commission's authority, under Section 728 of the Dodd-Frank Act, to establish standards and requirements related to reporting and recordkeeping for

<sup>36</sup> Current § 38.6 (Enforceability) remains unchanged.

<sup>37</sup> The Commission notes that in the recent notice of proposed rulemaking for Business Affiliate Marketing and Disposal of Consumer Information Rules, 75 FR 66018–01, Oct. 27, 2010 (to be codified at 17 CFR part 163) rules are proposed prohibiting FCMs (and other intermediaries) from using certain consumer information received from an affiliate to make a solicitation for marketing purposes. In addition, rules were proposed requiring FCMs to develop a written disposal program to the extent that such FCMs possess consumer information. The underlying policy for these rules is to protect the privacy of customer information. Similarly, this proposed rule is intended to protect market participant's information provided to a DCM for regulatory purposes from its use to advance the commercial interests of the DCM.

swaps.<sup>38</sup> In particular, the Commission is required to adopt consistent data element standards for "registered entities," which includes DCMs. part 45, which is being proposed in the separate Commission release "Data Recordkeeping and Reporting Requirements," will set forth the recordkeeping and reporting requirements for DCMs with respect to swaps.<sup>39</sup> Proposed § 38.8(b) codifies the obligations of DCMs to comply with the provisions of proposed part 45.

#### 8. Proposed § 38.9—Boards of Trade Operating Both a Designated Contract Market and a Swap Execution Facility

As noted above, the Dodd-Frank Act created a new regulated entity, the SEF, for the listing, trading and processing of swaps. The registration and compliance requirements for SEFs will be proposed in redesignated part 37, in a forthcoming release.<sup>40</sup> Under the Dodd-Frank Act, a DCM may list and trade swaps pursuant to its designation as a contract market. In addition, a board of trade that operates a DCM also may operate a SEF, provided that the board of trade separately registers as a SEF and complies with the applicable SEF core principles and any Commission regulations thereunder. Proposed § 38.9 codifies the requirement that a board of trade that operates a DCM and that intends to operate a SEF must separately register pursuant to the SEF registration requirements and, on an ongoing basis, must separately comply with the SEF rules and core principles under Section 5h of the CEA, as amended by the Dodd-Frank Act, and part 37 of the Commission's regulations.

Moreover, section 5h(c) of the CEA, as amended by the Dodd-Frank Act, provides that any board of trade that is a DCM and intends to operate as an independent SEF may use the same electronic trade execution system for listing and executing swaps, provided that the board of trade makes it clear to market participants whether the electronic trading of such swaps is taking place on or through the DCM or the SEF.<sup>41</sup> Proposed § 38.9(b) codifies this statutory requirement.

<sup>38</sup> *See* Section 21 of the CEA, as amended by the Dodd-Frank Act.

<sup>39</sup> *See* "Swap Data Recordkeeping and Reporting Requirements," Proposed Rule, 75 FR 76574 (Dec. 8, 2010).

<sup>40</sup> *See* CFTC Web site for additional information on the "SEF Registration Requirements and Core Principle Rulemaking, Interpretation & Guidance," at [http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF\\_13\\_SEFRules/index.htm](http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_13_SEFRules/index.htm) (last visited Dec. 14, 2010).

<sup>41</sup> Section 5h(c) of the CEA, as amended by the Dodd-Frank Act, provides:

### 9. Proposed § 38.10—Reporting of Swaps Traded on a Designated Contract Market

Section 727 of the Dodd-Frank Act directs the Commission to adopt rules providing for the public availability of swap transaction and pricing data in real-time.<sup>42</sup> To the extent that they make swaps available for trading and execution either on a SEF or a DCM, DCMs will have real-time public reporting obligations pursuant to the Dodd-Frank Act and, therefore, must comply with the applicable provisions governing real time reporting. The Commission is proposing regulations applicable to the real time swap reporting obligations of certain entities under a separate release.<sup>43</sup> The real time reporting regulations are proposed to be codified under part 43 of the Commission's regulations. In addition to the real time reporting obligations, the proposed rule also requires DCMs to comply with the swap reporting and recordkeeping requirements that are being proposed by the Commission in a separate release, and are proposed to be codified under part 45 of the Commission's regulations. Accordingly, proposed § 38.10 would codify the compliance obligations of DCMs with respect to real time reporting of swap transactions and swap data recordkeeping and reporting obligations, as may be required under proposed parts 43 and 45 of the Commission's regulations, respectively.

#### *D. Proposed New Regulations and Revised Guidance and Acceptable Practices For Compliance With the Core Principles*

As noted above, this release proposes to reorganize part 38 to include subparts A through X. As proposed, each of subparts B through X will include relevant regulations applicable to the 23 core principles. In addition to the proposed new regulations, the Commission proposes to codify within each subpart the statutory language of the respective core principle.<sup>44</sup>

IDENTIFICATION OF FACILITY USED TO TRADE SWAPS BY CONTRACT MARKETS.—A board of trade that operates a contract market shall, to the extent that the board of trade also operates a swap execution facility and uses the same electronic trade execution system for listing and executing trades of swaps on or through the contract market and the swap execution facility, identify whether the electronic trading of such swaps is taking place on or through the contract market or the swap execution facility.

<sup>42</sup> See Sections 2(a)(13)–(14) of the CEA, as amended by the Dodd-Frank Act.

<sup>43</sup> See “Real Time Public Reporting of Swap Transaction Data,” Proposed Rule, 75 FR 76140 (Dec. 7, 2010).

<sup>44</sup> In two instances, the language of the core principle, as codified, was slightly revised to add

### 1. Subpart B—Designation as Contract Market

The Dodd-Frank Act amends Core Principle 1 to make clear that compliance with the core principles, and any other rule or regulation that the Commission may impose under Section 8a(5) of the CEA, is a necessary condition to obtain and maintain designation as a contract market.<sup>45</sup> Amended Core Principle 1 provides that unless otherwise determined by the Commission by rule or regulation, DCMs will continue to have reasonable discretion in establishing the manner in which they comply with the core principles. The Commission proposes to codify the statutory text of Core Principle 1 in proposed § 38.100.

### 2. Subpart C—Compliance With Rules

Core Principle 2, as amended by the Dodd-Frank Act, requires that a DCM establish, monitor, and enforce its rules, including rules relating to access requirements, rules regarding the terms and conditions of any contract to be traded on the contract market, and rules prohibiting abusive trading practices. A DCM also must have the capacity to detect and investigate potential rule violations, and to sanction any person that violates its rules.<sup>46</sup> In addition, a DCM's rules must provide it with the ability and authority to perform the obligations and responsibilities required under Core Principle 2, including the capacity to carry-out such international information sharing agreements that the Commission may require. Proposed § 38.150 implements these requirements.

For the most part, the Commission is codifying: (1) Language found in the guidance and acceptable practices for Core Principle 2 and former designation criterion 8; (2) existing DCM compliance practices that the Commission believes constitute best practices; and (3) recommendations made over the past several years by the Commission in rule enforcement reviews.<sup>47</sup> In addition, the

references to the CEA where the statutory language simply cited to the CEA section without citing to the statute. These non-substantive edits were made to §§ 38.100 and 38.1200.

<sup>45</sup> 7 U.S.C. 7; see also Section 5(d)(1) of the CEA, as amended by the Dodd-Frank Act.

<sup>46</sup> As noted above, Section 735 of the Dodd-Frank Act amends Section 5 of the CEA to eliminate DCM designation criteria and amends several core principles, including Core Principle 2. Core Principle 2 was amended to include language formerly found in Designation Criterion 8—Ability to Obtain Information, and to specifically require that a DCM have the ability to detect, investigate, and sanction rule violations.

<sup>47</sup> Commission staff conducts periodic RERs of all DCMs. RERs examine DCM compliance with specific core principles over a one-year target period. Commission staff's analyses, conclusions

Commission is proposing some practices and requirements that are new for DCMs. The Commission also looked to and incorporated into the proposed rules for Core Principle 2 certain concepts that are currently contained in part 8 of its regulations—Exchange Procedures for Disciplinary, Summary, and Membership Denial Actions. In this regard, the Commission notes that most DCMs' compliance and enforcement practices relating to Core Principle 2 obligations historically have been consistent with the rules contained in part 8.<sup>48</sup> Each of the proposed rules under subpart C is discussed below.

#### i. Proposed § 38.151—Access Requirements

Proposed § 38.151 is an example of a rule in which the Commission proposes a new requirement for DCMs.<sup>49</sup> Proposed § 38.151(a) requires that prior to granting a member or market participant access to its markets, the DCM must require the member or market participant to consent to its jurisdiction. The growth of electronic trading in the futures industry and the transformation of futures exchanges from traditional membership organizations to demutualized for-profit entities has changed how individuals and firms access the markets and execute trades. When open outcry dominated trading, orders were typically called in to a desk on the trading floor and members on the floor executed trades. Today, on most DCMs, one does not need to be a “member” to enter an order on an electronic trading system. Rather, clearing members can provide their customers with access to a DCM's electronic trading system and customers can enter their own orders. Depending on the type of access granted by the clearing member, the customer's order either will go through the clearing member's system for risk management before hitting the DCM's electronic trading system or directly go into the DCM's trading system.

DCMs generally require through rule and/or clearing firm connection

and recommendations regarding any identified deficiencies are included in a publicly available written report.

<sup>48</sup> Section 38.2 of the Commission's regulations exempts DCMs from all Commission rules not specifically reserved. The part 8 rules were not reserved.

<sup>49</sup> Generally, § 38.151 is being proposed pursuant to the Commission's general rulemaking authority under Section 8a(5) of the CEA (providing the authority to “promulgate such rules \* \* \* reasonably necessary \* \* \* to accomplish any of the purposes of” the CEA), and Section 3 of the CEA (providing that the purposes of the Act include the promotion of “fair competition among boards of trade, other markets and market participants”). 7 U.S.C. 5, 12a(5).



agreements that prior to a clearing member granting a customer access to the DCM's electronic trading system, the clearing member secure its customer's agreement to abide by, and be subject to, the DCM's rules. Nevertheless, DCMs do not view themselves as having the jurisdiction needed to compel these market participants to participate in the investigation and disciplinary process. Although DCMs have the option of requiring a clearing firm to bar a customer from accessing the DCM if the DCM believes that the customer committed a rule violation, most DCMs will first request that the customer submit to its jurisdiction and participate in the investigation and disciplinary process before exercising this option.

Trading on a DCM is a privilege that is subject to conditions and entails certain responsibilities. The Commission believes that if a participant is granted the privilege of trading on a DCM, the participant should not only be required to abide by the DCM's rules, but the participant also must consent to the DCM's jurisdiction and participate in both the investigatory and disciplinary process. The Commission recognizes that this requirement will require clearing firms to amend their existing customer agreements to secure customers' agreements to submit to a DCM's jurisdiction. Accordingly, although DCMs would be required to implement proposed § 38.151(a) either by rule and/or modification of connection agreements by the effective date of the final rule, the proposed rule permits DCMs to allow their clearing firms up to 180 days to secure the necessary modifications to existing customer agreements.

Proposed § 38.151(b) requires that a DCM provide its members, market participants and ISVs with impartial access to its markets and services. This includes: 1) access criteria that are impartial, transparent, and applied in a non-discriminatory manner, and 2) comparable fee structures for members, market participants and independent software vendors ("ISV"),<sup>50</sup> receiving

<sup>50</sup> The Commission notes that examples of independent software vendors include: smart order routers, trading software companies that develop front-end trading applications, and aggregators of transaction data. Smart order routing generally involves scanning of the market for the best-displayed price and then routing orders to that market for execution. Software that serves as a front-end trading application is typically used by traders to input orders, monitor quotations and view a record of the transactions completed during a trading session. Aggregators of transaction data provide access to news, analytics and execution services. The Commission believes that transparency and trading efficiency would be enhanced as a result of innovations in this field for

equal access to, or services from the DCM. The purpose of the proposed impartial access requirements is to prevent DCMs from using discriminatory access requirements as a competitive tool against certain participants. Access to a DCM should be based on the financial and operational soundness of a participant, rather than discriminatory or other improper motives.<sup>51</sup> Any participant should be able to demonstrate financial soundness either by showing that it is a clearing member of a DCO that clears products traded on that DCM or by showing that it has clearing arrangements in place with such a clearing member. Furthermore, granting impartial access to participants that satisfy a DCM's access requirements may enhance the DCM's liquidity and the overall transparency of the swaps and futures markets.

A DCM can satisfy the requirement that membership and participation criteria are impartial, transparent, and non-discriminatory by establishing clear and impartial guidelines and procedures for granting access to its facilities and publishing such guidelines and procedures on its Web site. Such requirements may establish different categories of market participants, but may not discriminate within a particular category. Fee structures may differ among categories if such fee structures are reasonably related to the cost of providing access or services to a particular category. For example, if a certain category requires greater information technology or administrative expenses on the part of the DCM, then a DCM may recoup those costs in establishing fees for that category of member or market participant.

Proposed § 38.151(c) (Limitations on Access) requires a DCM to establish and impartially enforce rules governing any decision by the DCM to deny, suspend, or permanently bar a member's or market participant's access to the contract market. While paragraph (b) of proposed § 38.151 requires impartiality in a DCM's decision to grant access, paragraph (c) addresses the converse

market services. For instance, certain providers of market services with access to multiple trading systems or platforms could provide consolidated transaction data from such trading systems or platforms to market participants.

<sup>51</sup> The Commission believes that the requirement to provide impartial access requires DCMs to avoid the creation of exclusive membership standards that focus on high net worth. Therefore, any participant should be able to demonstrate financial soundness either by showing that it is a clearing member of a DCO that clears products traded on that DCM or by showing that it has clearing arrangements in place with such a clearing member.

situation where a DCM wishes to deny access, or to revoke the access of members or market participants who already possess it. Proposed § 38.151(c) gives specific examples of when such situations might arise, including DCM disciplinary proceedings or emergency actions. As with decisions to grant access, any decision by a DCM to deny, suspend, or permanently bar a member's or market participant's access to the DCM must be impartial and applied in a non-discriminatory manner.

#### ii. Proposed § 38.152—Abusive Trading Practices Prohibited

Proposed § 38.152 requires that a DCM prohibit enumerated abusive trading practices. The listed practices are a compilation of abusive trading practices that DCMs already prohibit. A DCM permitting intermediation must prohibit specific trading practices, including trading ahead of customer orders, trading against customer orders, accommodation trading, and improper cross-trading. Specific trading practices that must be prohibited by all DCMs include front-running, wash trading, pre-arranged trading, fraudulent trading, money passes and any other trading practices that the DCM deems to be abusive. In addition, a DCM also must prohibit any other manipulative or disruptive trading practices prohibited by the CEA or by the Commission pursuant to Commission regulation.<sup>52</sup>

#### iii. Proposed § 38.153—Capacity To Detect and Investigate Rule Violations

Proposed § 38.153 is based on the current application guidance for Core Principle 2.<sup>53</sup> The proposed rule requires that a DCM have arrangements and resources for effective rule enforcement. This includes the authority to collect information and examine books and records of members and market participants.<sup>54</sup> By its terms, Core Principle 2 requires a DCM to have, in addition to appropriate resources for trade practice surveillance

<sup>52</sup> Section 747 of the Dodd-Frank Act amends Section 4c(a) of the CEA by adding three disruptive practices which make it: unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that—

(A) Violates bids or offers;

(B) Demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period; or

(C) Is, of the character of, or is commonly known to the trade as, 'spoofing' (bidding or offering with the intent to cancel the bid or offer before execution).

<sup>53</sup> 17 CFR part 38, App. B, Core Principle 2, Application Guidance at ¶ 1.

<sup>54</sup> The language in the current application guidance requires that a DCM "have arrangements and resources for effective trade practice surveillance programs[.]" *Id.*

programs, appropriate resources to enforce all of its rules.

The proposed rule also requires a DCM to have the authority to examine books and records for all market participants rather than limiting that authority to “non-intermediated market participants” as such authority was limited in the former application guidance. A DCM can best administer its compliance and rule enforcement obligations if it has the ability to reach the books and records of all market participants, rather than a subset of market participants.

#### iv. Proposed § 38.154—Regulatory Services Provided by a Third Party

The CEA provides that a DCM may comply with applicable core principles by delegating relevant functions to a registered futures association or another registered entity.<sup>55</sup> The Commission also has described acceptable “contracting” arrangements for the performance of core principle functions by third-parties.<sup>56</sup> In this context, the term “contracting” implies a lesser transference of authority to the third-party than does “delegating.” In all cases, however, the Commission has specified, as required under the CEA,<sup>57</sup> that DCMs remain responsible for carrying out any function delegated or contracted to a third party and that DCMs must ensure that the services received will enable them to remain in compliance with the CEA’s requirements.

In recent years, the Commission has gained much experience in administering the delegation and contracting regime for regulatory services. Many DCMs, especially those that were designated after passage of the CFMA, employ third-party regulatory service providers to meet one or more core principle obligations. In administering this regime, the Commission has found that DCM applicants have questions as to the manner and degree to which their staffs must remain involved in regulatory decisions when they utilize third-party providers. Accordingly, the Commission is proposing new § 38.154 to supplement its previous guidance on delegation and contracting arrangements to clarify its expectations in this regard. The proposed rule is equally applicable to delegations and contracting, and to arrangements DCMs have with regulatory service providers that are

registered futures associations or other registered entities. For purposes of proposed § 38.154, the applicable self-regulatory functions include: trade practice surveillance; market surveillance; real-time market monitoring; investigations of possible rule violations; and disciplinary actions.

The proposed rule requires that DCMs utilizing third-party regulatory service providers must ensure that their providers have sufficient capacity and resources to render timely and effective regulatory services. The DCM also must oversee the quality of the contracted regulatory services and must retain *exclusive* authority with respect to certain regulatory decisions. These regulatory decisions include cancellation of trades, the issuance of disciplinary charges against members or market participants, and denials of access to the trading platform for disciplinary reasons. Conversely, the proposed rule also specifies that a decision to open an investigation of a possible rule violation must be made solely by a regulatory service provider, and all instances where a DCM’s actions differ from those recommended by its regulatory provider must be documented and explained in writing.

#### v. Proposed § 38.155—Compliance Staff and Resources

As noted above, Core Principle 2 requires that a DCM enforce compliance with its rules and have the capacity to detect, investigate, and sanction violations. Having adequate staff to perform a DCM’s compliance and enforcement responsibilities is essential to the effectiveness of its self-regulatory programs, including market surveillance, audit trail, trade practice surveillance, and disciplinary programs.

A DCM’s ability to enforce speculative limits, monitor for manipulation, complete timely investigations, conduct annual open outcry and electronic audit trail reviews, as well as perform other regulatory duties, is compromised if a DCM does not have sufficient staff. Thus, examining the size and experience of a DCM’s compliance staff is a critical component of RERs carried out by Commission staff. In several RERs, staff has recommended, and the Commission has accepted, findings that DCMs: (1) increase their compliance staff levels, and (2) monitor the size of their staffs and increase the number of staff appropriately as trading volume increases, new responsibilities are assigned to compliance staff, or internal reviews demonstrate that work is not

completed in an effective or timely manner.<sup>58</sup>

Those recommendations have formed the basis for proposed § 38.155. The proposed rule requires that a DCM maintain sufficient compliance resources to conduct effective audit trail reviews, trade practice surveillance, market surveillance, and real-time monitoring. It also requires that a DCM monitor its staff size annually to ensure that it is appropriate to effectively perform those functions. Staff size also must be sufficient to address market or trading events and to complete investigations in a timely manner.

The Commission is not proposing that staff size be determined based on a specific formula. Rather, the Commission proposes to leave to the discretion of each individual DCM to determine the size of the staff it needs to effectively perform its self-regulatory responsibilities. In making this determination, the proposed rule requires that a DCM take into account specific facts and circumstances (*e.g.*, volume, the number of new contracts, *etc.*), as well as any other factors suggesting the need for increased resources. Factors that may suggest the need for increased compliance resources are a prolonged surge in trading volume or a prolonged period of price volatility. A DCM must have sufficient staff to address unusual or unanticipated events while continuing to effectively conduct its routine self-regulatory duties.

#### vi. Proposed § 38.156—Automated Trade Surveillance System

All currently active DCMs, or their third-party service providers, maintain automated surveillance systems to conduct trade practice surveillance. These systems vary in degree of sophistication, but typically generate alerts on a trade date plus one day (T+1) basis to help staff focus on potential violations and anomalies found in trade data.<sup>59</sup> They also provide a DCM’s compliance staff the ability to sort and query voluminous amounts of data. In performing their surveillance responsibilities, DCMs engage in various analyses to profile trading activity and conduct investigations to detect and prosecute possible trading abuses. These functions all require the collection of order and trade data and the ability to

<sup>55</sup> 7 U.S.C. 7a–2(b); *see also*, section 5c(b)(1) of the CEA, as amended by the Dodd-Frank Act.

<sup>56</sup> *See* 66 FR 42256, 42266, Aug. 10, 2001.

<sup>57</sup> *See* 7 U.S.C. 7a–2(b)(2); *see also*, Section 5c(b)(2) of the CEA, as amended by the Dodd-Frank Act.

<sup>58</sup> *See* Rule Enforcement Review of the Minneapolis Grain Exchange (Aug. 27, 2009); Rule Enforcement Review of ICE Futures U.S. (Feb. 2, 2010); and Rule Enforcement Review of the Chicago Board of Trade and the Chicago Mercantile Exchange (Sep. 13, 2010).

<sup>59</sup> These systems typically differ from those systems used for real-time market monitoring. The requirements for real-time market monitoring can be found in proposed § 38.157.

process that data in various ways for analysis.

Proposed § 38.156 reflects the substantial growth in U.S. futures trading volume since the CFMA was adopted in 2000. The approximate trading volume for U.S. futures exchanges (including futures and options on futures) was 596 million contracts in 2000, 2 billion contracts in 2005, and 3.2 billion contracts in 2010. In view of this growth in volume, combined with new participants in the markets, such as high frequency traders, it is critical that DCMs have automated tools that, at a minimum, have the capability to generate alerts, profile trading activity, and sort and query data to conduct trade practice surveillance. The Commission has found, in performing its oversight responsibility of monitoring the markets to ensure market integrity and customer protection, that effectively monitoring this large amount of volume requires automated tools.<sup>60</sup> A DCM's automated surveillance system must have specific characteristics for it to be able to detect and prosecute the abusive trading practices enumerated in proposed § 38.152. A DCM's automated surveillance system must maintain all trade and order data, including order modifications and cancellations. The system must process this data on a T+1 basis. In addition, a DCM's automated trade surveillance system must provide users with the ability to compute, retain and compare trading statistics; compute profit and loss; and reconstruct the sequence of trading activity.

vii. Proposed § 38.157—Real-time Market Monitoring

Proposed § 38.157 codifies existing practices at DCMs for real-time monitoring of electronic trading. The practices codified in proposed § 38.157 reflect the growth of electronic trading in the U.S. futures markets, as well as the Commission's experience in designating new contract markets since passage of the CFMA. All DCMs that were designated post-CFMA trade exclusively on electronic trading platforms.

The purpose of real-time monitoring of electronic trading is to ensure orderly trading and to identify and correct any market or system anomalies promptly. The proposed rule requires that any DCM price adjustment or trade cancellation process be clear and transparent to the market and subject to

clear, fair and publicly-available standards.

viii. Proposed § 38.158—Investigations and Investigation Reports

Proposed § 38.158 is largely a compilation of requirements found in §§ 8.06 and 8.07 of the Commission's regulations, with some modifications. Paragraph (a) of the proposed rule requires that a DCM have procedures to conduct investigations of possible rule violations. Paragraph (b) requires that an investigation be completed within a timely manner. A timely manner is defined to be 12 months after an investigation is opened, absent mitigating circumstances. This differs from § 8.06(b) of the Commission's regulations, which provides that an investigation be "completed within four months, unless significant reasons exist to extend it beyond such period." In its experience in conducting RERs, the Commission has found that while simple, straight-forward investigations typically are completed in less than four months, many DCM investigations involve fact patterns requiring more in-depth and sophisticated analysis. Depending on the complexity of a matter, an investigation frequently may take between four and 12 months to complete.

While it is not typical for an investigation to take longer than one year to complete, certain circumstances may justify an investigation taking longer than one year. These include the complexity of the investigation, the number of firms or individuals involved, the number of potential violations, the amount of trade data requiring analysis and, in some instances, the amount of video recordings to be reviewed and analyzed.<sup>61</sup>

Paragraphs (c) and (d) of proposed § 38.158 set forth the elements and information that must be included in an investigation report when there is or there is not a reasonable basis for finding a rule violation. While the proposed language is similar to §§ 8.07(a) and (b) of the Commission's regulations, there are two notable differences.

First, proposed § 38.158(c) requires that when DCM compliance staff believes there is a reasonable basis for finding a violation, the investigation report must include the potential wrongdoer's disciplinary history.

<sup>61</sup> See Rule Enforcement Review of ICE Futures U.S. (Feb. 2, 2010), and Rule Enforcement Review of the Chicago Board of Trade and the Chicago Mercantile Exchange (Sep. 13, 2010). Some exchanges, such as CBOT and CME, have video cameras on their open outcry trading floors.

Second, proposed § 38.158(d) requires that if a DCM's compliance staff recommends that a warning letter be issued, the investigation report must also include the potential wrongdoer's disciplinary history.<sup>62</sup> Requiring disclosure of a member's or market participant's prior disciplinary history in the above-described circumstances is consistent with recommendations made in RERs.<sup>63</sup> The Commission believes that prior disciplinary history is critical information that a disciplinary committee should consider when either issuing a warning letter or assessing an appropriate penalty as part of any settlement decision or hearing.<sup>64</sup> In practice, when a DCM's compliance department believes there is a reasonable basis to find a violation, the investigation report is forwarded to a disciplinary committee for action. Therefore, the Commission believes that the investigation report is the most logical place to include disciplinary history.

Proposed § 38.158(e) provides that a DCM may authorize its compliance staff to issue a warning letter or to recommend that a disciplinary committee issue a warning letter. The proposed rule is substantively identical to Commission § 8.07(c), except that it prohibits a DCM from issuing more than one warning letter for the same violation during a rolling 12-month period. Currently, many DCMs use summary fine programs to enforce their audit trail rules. Typically, such programs allow compliance staff to issue summary fines for trade timing, order ticket and trading card violations. Such summary fine schemes generally start with a warning letter for the first offense. While a warning letter may be appropriate for a first-time violation, the Commission does not believe that more than one warning letter in a rolling 12-month period for the same or similar violation is ever appropriate. A policy of issuing repeated warning letters, rather than issuing meaningful sanctions, to members and market participants who repeatedly violate the same or similar rules denigrates the effectiveness of a

<sup>62</sup> In some instances, even though there is not sufficient evidence to recommend disciplinary action, a DCM's compliance staff may believe that a rule violation occurred.

<sup>63</sup> See 2000 Rule Enforcement Review of the New York Mercantile Exchange.

<sup>64</sup> As noted below in the discussion of proposed § 38.158(c), a DCM's disciplinary committee should review a member's complete disciplinary history when determining appropriate sanctions and impose meaningful sanctions on members who repeatedly violate the same or similar rules to discourage recidivist activity.

<sup>60</sup> In this regard, the Commission is in the midst of modifying its own automated surveillance systems for both trade practice surveillance and market surveillance.

DCM's rule enforcement program.<sup>65</sup> The proposed rule is consistent with what Commission staff has advised DCM applicants and recommendations made in RERs.<sup>66</sup>

ix. Proposed § 38.159—Ability To Obtain Information

Proposed § 38.159 expands on the Core Principle 2 requirement that a DCM have the ability and authority to obtain necessary information to perform its rule enforcement obligations, including the capacity to carry out any international information sharing agreements required by the Commission. The proposed rule provides that information sharing agreements can be established with other DCMs or SEFs, or that the Commission can act in conjunction with a DCM to carry out such information sharing. This language is virtually identical to the language found in the guidance for former Designation Criterion 8.<sup>67</sup>

x. Proposed § 38.160—Additional Rules Required

Proposed § 38.160 requires a DCM to adopt and enforce any additional rules that it believes are necessary to comply with the requirements of this subpart C.

3. Subpart D—Contracts Not Readily Subject to Manipulation

The Dodd-Frank Act did not make any amendments to current Core Principle 3—Contracts Not Readily Subject to Manipulation. Historically, DCMs complied with the requirements of Core Principle 3 by using as guidance the provisions of Guideline No. 1, contained in Appendix A to part 40. The Commission proposes certain revisions to the former Guideline No. 1, including: (1) Amending the provision to include swap transactions, (2) re-titling the guidance as “Demonstration of compliance that a contract is not readily susceptible to manipulation,” and (3) redesignating the provision as Appendix C of part 38. Proposed § 38.201 refers applicants and DCMs to the guidance in Appendix C to part 38 for purposes of demonstrating to the Commission their compliance with the requirements of § 38.200. Proposed guidance under Appendix C to part 38 would replace Guideline No. 1 under Appendix A to part 40.

<sup>65</sup> For purposes of this rule, the Commission does not consider a “reminder letter” or such other similar letter to be any different than a warning letter.

<sup>66</sup> See 1998 Rule Enforcement Review of Kansas City Board of Trade; and, Rule Enforcement Review of the Minneapolis Grain Exchange (Aug. 27, 2009).

<sup>67</sup> 17 CFR Part 38, App. A, Designation Criterion 8, Guidance.

The amended guidance provides greater detail to DCMs regarding the relevant considerations in demonstrating compliance with Core Principle 3 when designing a contract and submitting supporting documentation and data to the Commission at the time the DCM submits: (1) The terms and conditions of a new contract under §§ 40.2 or 40.3, or (2) amendments to terms and conditions under §§ 40.5 or 40.6.

In general, the guidance provides that the settlement or delivery procedures adopted by a DCM for a futures contract should reflect the underlying cash market. The objective is to ensure that a given futures contract is not readily susceptible to manipulation and that it will provide a reliable pricing basis and promote cash/futures price convergence. Accordingly, the terms and conditions should conform to prevailing commercial practices and provide for adequate deliverable supply.

For cash-settled contracts, the cash-settlement procedure should be based on a reliable price reference series that accurately reflects the underlying market value, is not readily susceptible to manipulation, and is commonly used by industry/market participants as a price reference. Therefore, the calculation methodology of the price reference series, if applicable, must be submitted as supporting documentation. In that regard, for a price reference series that is based on an index or survey of prices or rates, this would include the index or survey methodology used to determine the level of the index used as the price reference. Furthermore, the views and opinions of prospective market users of the contracts should be given considerable weight in the contract design process. The more accurately a listed contract's terms and conditions reflect the underlying cash market in that commodity, the more likely the contract will perform the intended risk management and/or price discovery functions. Finally, a DCM should ensure that the terms and conditions of listed contracts remain consistent with the guidance set forth herein. These concepts are set forth in the guidance in Appendix C to part 38.

The guidance in Appendix C to part 38 is comprised of best practices that were developed over the past three decades by the Commission and other market regulators in their review of product submissions. The Commission first adopted a Guideline for product submissions on November 3, 1982<sup>68</sup> and since then has modified it from

<sup>68</sup> See 47 FR 49832, 49838, Nov. 3, 1982.

time to time. Furthermore, the Commission's Guideline served as the basis for “Guidance on Standards of Best Practice for the Design and/or Review of Commodity Contracts,” endorsed by the International Organization of Securities Commissioners (“IOSCO”) in its Tokyo Communiqué (October 1997).<sup>69</sup> The Guidance recognizes that the proper design of the terms and conditions of contracts reduces the susceptibility of such contracts to market abuses, including manipulation, and enhances the economic utility of such contracts to commercial users. Accordingly, the Guidance for designing futures contracts focuses on such issues as a contract's economic utility (*i.e.*, a contract should meet risk management needs of potential users and/or promote price discovery of the underlying commodity), the contract's correlation with the cash market (*i.e.*, the contract terms and conditions generally should reflect the operation of the underlying cash market and avoid impediments to delivery), a contract's settlement and delivery reliability (*i.e.*, the settlement and delivery procedures should reflect the underlying cash market and promote price convergence), the contract's responsiveness to the views of potential market users, and the contract's transparency (*i.e.*, the contract's terms and conditions, as well as relevant information concerning delivery and pricing, should be readily available to market authorities and to market users).

Appendix C to part 38 is intended to act as a source for new and existing DCMs to reference for best practices when developing new products to list for trading. Specifically, Appendix C to part 38 provides guidance regarding: (1) The forms of supporting information a new contract submission should include; (2) how to estimate deliverable supplies; (3) the contract terms and conditions that should be specified for physically delivered contracts; (4) how to demonstrate that a cash-settled contract is reflective of the underlying cash market, is not readily subject to manipulation or distortion, and is based on a cash price series that is reliable, acceptable, publicly available and timely; (5) the contract terms and conditions that should be specified for cash-settled contracts; (6) the requirements for options on futures contracts; (7) the terms and conditions for non-price based futures contracts; and (8) the terms and conditions for

<sup>69</sup> See Tokyo Commodity Futures Markets Regulators' Conference (October, 1997), [http://www.cftc.gov/ucm/groups/public/@internationalaffairs/documents/file/oia\\_tokyorpt.pdf](http://www.cftc.gov/ucm/groups/public/@internationalaffairs/documents/file/oia_tokyorpt.pdf) (last visited Oct. 25, 2010).

swap contracts. Currently, DCMs generally conduct market research in a manner discussed in Appendix C.

#### 4. Subpart E—Prevention of Market Disruption

The Dodd-Frank Act amended current Core Principle 4 by: (i) Changing the title of the core principle from “Monitoring of Trading” to “Prevention of Market Disruptions;” and (ii) specifying the methods and procedures DCMs must employ in discharging their obligations under Core Principle 4. The amendments to Core Principle 4 emphasize that DCMs must take an active role, not only in monitoring trading activities within their markets, but in preventing market disruptions. Accordingly, the proposed rules under subpart E of part 38 codify the relevant provisions of the current Application Guidance and Acceptable Practices for Core Principle 4 in current Appendix B to part 38, and include new requirements that clarify and strengthen a DCM’s responsibilities under the amended core principle.

##### i. Proposed § 38.251—General Requirements

As noted above, the Dodd-Frank Act amended Section 5(d)(4) of the CEA by adding new language to Core Principle 4 to require DCMs to conduct real-time monitoring of trading and to have the ability to comprehensively and accurately reconstruct trading.<sup>70</sup> Accordingly, proposed § 38.251 (General Requirements) would require that the DCM have the ability to conduct real-time monitoring of trading and comprehensive and accurate trade reconstructions. Intra-day trade monitoring must include the capacity to detect abnormal price movements, unusual trading volumes, impairments to market liquidity, and position-limit violations.

As noted above in its discussion of the need for automated tools in connection with Core Principle 2 requirements, the Commission believes that it would be difficult, if not impossible, to monitor for market disruptions in contract markets with high transaction volume and a large number of trades unless the DCM has installed automated trading alerts to detect many types of potential violations of exchange or Commission rules. Accordingly, the Commission proposes in § 38.251 to require that, where the DCM cannot reasonably demonstrate that its manual processes are effective in detecting and preventing abuses, the DCM must implement

automated trading alerts to detect potential problems.

We invite comment on whether in any rule the Commission may adopt in this matter DCMs should be required to monitor the extent of high frequency trading, and whether automated trading systems should include the ability to detect and flag high frequency trading anomalies.

##### ii. Proposed § 38.252—Additional Requirements for Physical Delivery Contracts

The Commission has observed a number of physically-delivered futures contracts where the convergence of the futures price and the cash market price of the underlying commodity have been problematic.<sup>71</sup> Price convergence refers to the process whereby the price of a physically-delivered futures contract converges to the spot price of the underlying commodity, as the futures contract nears expiration (a cash-settled contract, by definition, converges to the underlying price series at expiration). The hedging effectiveness of a physically-delivered futures contract depends in part upon the extent to which the futures price reliably converges to the comparable cash market price, or to a predictable differential to the comparable cash market price. The delivery mechanism for physically-delivered futures contracts is the critical link that drives price convergence. To the extent that delivery of a commodity at futures expiration occurs and the delivered commodity is merchandised in the physical marketing channel, arbitrage should ensure that the price of the futures contract converges to the price of the commodity in the physical marketing channel. Impediments to futures delivery, or the delivery of an instrument that permits a long futures position holder to defer moving the

<sup>71</sup> The Commission notes that the lack of convergence and its adverse impact on the ability to effectively hedge in some agricultural futures markets has been the subject of several meetings of the Commission’s Agricultural Advisory Committee. Where there is a lack of convergence, this has resulted in extremely weak bases, *i.e.*, cash prices well below equivalent futures prices, disadvantaging short hedgers and resulting in abnormally large quantities of futures deliveries that diverted grain from normal commercial channels and tied up warehouse space. The lack of convergence likely sends the wrong price discovery signals to the market. *See*, Materials from Meeting of the CFTC’s Agricultural Advisory Committee (AAC) (October 29, 2009), [http://www.cftc.gov/About/CFTCCcommittees/AgriculturalAdvisory/aac\\_102909agenda.html](http://www.cftc.gov/About/CFTCCcommittees/AgriculturalAdvisory/aac_102909agenda.html); *see also*, the AAC Subcommittee on Convergence in Agricultural Commodity Markets Report and Recommendations (October 29, 2009), <http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/reportofthesubcommitteeonconve.pdf>.

physical commodity into normal marketing channels, may weaken the crucial link between cash markets and the futures market, resulting in a lack of reliable price convergence.<sup>72</sup>

Therefore, for physical delivery contracts, proposed § 38.252 specifically requires that, among other things, DCMs must monitor each contract’s terms and conditions as to whether there is convergence of the futures price to the cash price of the underlying commodity and take meaningful corrective action, including to address conditions that interfere with convergence, or if appropriate, change contract terms and conditions, when lack of convergence impacts the ability to use the markets for making hedging decisions and for price discovery.

The Commission requests comments on what other factors, in addition to the delivery mechanism, a DCM should be required to consider in determining whether convergence is occurring.

##### iii. Proposed § 38.253—Additional Requirements for Cash-Settled Contracts

Over the past several years, there has been a growth in markets that are linked, for example, where the settlement price of one market is linked to the prices established in another market. As a result, traders may have incentives to disrupt or manipulate prices in the reference market in order to influence the prices in the linked market. Accordingly, proposed § 38.253 would require that, where a DCM contract is settled by reference to the price of a contract or instrument traded in another venue, including a price or index derived from prices on another exchange, the DCM must have rules that require the traders on the DCM’s market to provide the DCM with their positions in the reference market as the traders’ contracts approach settlement. In the alternative, § 38.253 provides that the DCM may have an information sharing agreement with the other venue or designated contract market.

##### iv. Proposed § 38.254—Ability To Obtain Information

The current acceptable practice for Core Principle 4 provides that DCMs, at a minimum, should have routine access to the positions and trading of their market participants. To ensure that the DCM has the ability to properly assess

<sup>72</sup> For example, specifying a shipping certificate with an indefinite life as the futures delivery instrument that permits a long futures position holder to avoid taking delivery in the physical marketing channel, which, in certain circumstances, may result in weak or erratic convergence between the futures price and the cash price.

<sup>70</sup> *See* Section 735 of the Dodd-Frank Act.

the potential for price manipulation, price distortions, and the disruption of the delivery or cash-settlement process, proposed § 38.254 provides that each DCM require that traders in their market keep records, including records of their activity in the underlying commodity and related derivative markets and contracts, and make such records available, upon request, to the designated contract market. The Commission's own market surveillance staff, which has similar authority to obtain information from large traders (under § 18.05 for futures and options and proposed § 20.6 for swaps), has found that access to such information is vital to an effective surveillance program.

#### v. Proposed § 38.255—Risk Controls for Trading

Proposed § 38.255 requires that a DCM have effective risk controls to reduce the potential risk of market disruptions and ensure orderly market conditions. In the current futures markets, DCMs have implemented a variety of risk controls to avoid market disruptions through restrictions on order entry, including daily price limits, price/quantity bands, and trading pauses. Most commonly used by DCMs for futures contracts in physical commodities (outside of the spot month) and futures contracts in broad-based equity indexes (in coordination with circuit breakers on national security exchanges) are daily price limits, which restrict the total price movement allowed on any given trading day, calculated as a limit above and below the prior day's futures settlement price.<sup>73</sup> Under daily price limits, futures can continue to trade within the limit up/down prices, but no trading can take place above or below the daily price limit. Some DCMs also have rules for the automatic expansion of the daily price limit after consecutive days of limit bid/offer prices. Some electronic trading platforms also have "reasonability tests" and/or "price bands" for order entry, which do not allow an order to enter the trade matching system if it is outside a predetermined price range or is of a particularly large size.<sup>74</sup> Finally, some trading platforms use trading pauses to halt trading for a short period of time during certain market conditions.

<sup>73</sup> Option contracts on futures may have different daily price limits than the underlying futures.

<sup>74</sup> For example, the GLOBEX electronic trading system for the NYMEX crude oil futures contract generally will not accept an order 75 points above or below the last traded price nor will it accept an order for a quantity larger than 999 contracts.

Trading pauses are used,<sup>75</sup> most commonly, for trading in equity index products.

The CME's GLOBEX system also has a risk control, commonly referred to as "stop logic functionality," that implements a pause of a few seconds in the order matching system to protect against cascading stop orders—the domino effect of one stop order triggering others. The stop logic functionality pauses trading when the last transaction price would have triggered a series of stop loss orders that, if executed, would cause the market to trade outside of predefined values, which typically consist of values that are the same as the "no bust" range<sup>76</sup> established for a market.

In order to prevent market disruptions due to sudden volatile price movements, proposed § 38.255 requires DCMs to have in place effective risk controls, including but not limited to pauses and/or halts to trading in the event of extraordinary price movements that may result in distorted prices or trigger market disruptions. Risk controls such as trading pauses and halts can, among other things, allow time for participants to analyze the market impact of new information that may have caused a sudden market move, allow new orders to come into a market that has moved dramatically, and allow traders to assess and secure their capital needs in the face of potential margin calls. Moreover, where a contract market can be a proxy or substitute for similar markets on the DCM or on other trading venues, including where a contract is based on the price of an equity security or the level of an equity index, risk controls should be coordinated with those on the similar markets or trading venues, to the extent possible. The desirability of coordination of various risk controls, for example, "circuit breakers" in equities and their various derivatives including futures and options, recently has been the subject of discussions by regulators and the industry.

The Commission believes that pauses and halts are effective risk management tools and must be implemented by DCMs to facilitate orderly markets.

<sup>75</sup> The NYMEX Henry Hub Natural Gas (NG) futures has a 5 minute pause in trading when a daily price limit—up or down—is hit, then trading resumes at a higher limit. However, this provision does not apply during the last 60 minutes of regular trading hours. See NYMEX rule 220.08.

<sup>76</sup> Under most exchanges' trade cancellation rules, trades considered to have been executed in error may be cancelled. Where the trade is within the "no bust range" for the specified futures contract, which range is determined by the exchange under its rules, the exchange will allow the trade to stand.

These basic risk controls also have proven to be effective and necessary in preventing market disruptions. The Commission requests comments on what types of pauses and halts are necessary and appropriate for particular market conditions. The Commission recognizes that pauses and halts are only one category of risk controls and that additional controls may be necessary to further reduce the potential for market disruptions. Such controls may include price collars or bands,<sup>77</sup> maximum order size limits,<sup>78</sup> stop loss order protections,<sup>79</sup> kill button,<sup>80</sup> and others. The Commission is considering mandating in this rulemaking risk controls that are appropriate and/or necessary. Accordingly, the Commission invites comments on the appropriateness of these and other controls that could supplement trading halts or pauses. The Commission also invites comments on the following additional questions:

- What other DCM risk controls are appropriate or necessary to reduce the risk of market disruptions?
- Which risk controls should be mandated and how?

#### vi. Proposed § 38.256—Trade Reconstruction

The Dodd-Frank Act added language to Core Principle 4 that designated contract markets must have the ability to comprehensively and accurately reconstruct all trading on its trading facility. These audit-trail data and reconstructions must also be made available to the Commission in a form, manner, and time as determined by the Commission. Proposed § 38.256 codifies these requirements.

#### vii. Proposed § 38.257—Regulatory Service Provider

Proposed § 38.257 provides that a designated contract market must comply with the regulations in this section

<sup>77</sup> Price bands would prevent clearly erroneous orders from entering the trading system, including "fat finger" errors, by automatically rejecting orders priced outside of a range of reasonability.

<sup>78</sup> Maximum order size limitations prevent entry into the trading system of an order that exceeds a maximum quantity established by the DCM.

<sup>79</sup> Stop loss orders would be triggered if the market declines to a level pre-selected by the person entering the order. This mechanism would provide that when the market declines to the trader's pre-selected stop level for such an order, the order would become a limit order executable only down to a price within the range of reasonability permitted by the system, instead of becoming a market order.

<sup>80</sup> The kill button gives clearinghouses associated with the DCM the ability to delete open orders and quotes and reject entry of new orders or quotes in instances where a trader breaches its obligations with the clearinghouse. FIA Market Access Risk Management Recommendations, p. 10 (April 2010).

through a dedicated regulatory department, or by delegation of that function to a regulatory service provider, over which the designated market has supervisory authority.

viii. Proposed § 38.258—Additional Rules Required

Proposed § 38.258 requires a DCM to adopt and enforce any additional rules that it believes are necessary to comply with the requirements of subpart E.

5. Subpart F—Position Limitations or Accountability

Core Principle 5 under Section 5(d)(5) requires that DCMs adopt for each contract, as is necessary and appropriate, position limitations or position accountability. The Dodd-Frank Act amended Core Principle 5 by adding that for any contract that is subject to a position limitation established by the Commission pursuant to Section 4a(a) of the CEA, the DCM shall set the position limitation of the board of trade at a level not higher than the position limitation established by the Commission. The Federal position limits established by the Commission currently are codified in part 150. In a separate release, as required by the Dodd-Frank Act, the Commission will consider replacing part 150 (Limits on Positions) with new part 151 (Limits on Positions) to establish Federal position limits for certain exempt and agricultural commodities that currently are not subject to Federal position limits.<sup>81</sup> In that release, the Commission will propose to require that exchanges adopt their own position limits for all commodities (whether such commodities are subject to Federal limits or not), with an alternative of adopting position accountability rules in lieu of position limits for contracts in major currencies and certain excluded commodities. Proposed § 38.301 requires that each DCM must comply with the requirements of part 151 that the Commission adopts in order to be in compliance with Core Principle 5.

6. Subpart G—Emergency Authority

The Dodd-Frank Act made minor, non-substantive changes to Core Principle 6 under Section 5(d)(6) of the CEA. Based upon its experience, and in recognition of the fact that DCMs may have different procedures and guidelines for taking emergency action, the Commission believes that it is appropriate to maintain an expanded

version of the existing guidance and add an acceptable practice under its regulations for purposes of complying with this core principle. As a result, the Commission proposes to retain most of the former Application Guidance found in Appendix B to part 38 of the Commission's regulations, with some revisions and additions. Proposed § 38.351 refers applicants and DCMs to the guidance and acceptable practices in Appendix B to part 38 for purposes of demonstrating to the Commission their compliance with the requirements of subpart G. Specifically, a DCM is required to have rules providing it with the authority to intervene as necessary to maintain fair and orderly trading and to prevent or address manipulation or disruptive trading practices, whether the need for intervention arises exclusively from the DCM's own market or as part of a coordinated, cross-market intervention. The increased tendency for similar, if not identical, contracts to be traded on more than one venue, that in the future may include a SEF, demonstrates the importance of coordinated interventions. Accordingly, the Commission believes that there should be an increased emphasis on cross-market coordination of emergency actions. The guidance also provides that the DCM rules should include procedures and guidelines to avoid conflicts of interest in accordance with new provisions proposed in § 40.9 and to include alternate lines of communication and approval procedures in order to be able to address, in real time, emergencies that may arise. This latter provision is a result of the expansion of electronic markets and the speed of order execution. As a result of fast-paced trading systems, there is a need for DCMs to be able to react quickly to market events and intervene without delay. Thus, the proposed guidance acknowledges this trend with this provision. The proposed guidance also clarifies that the DCM must also have rules that allow it to take such market actions as may be directed by the Commission.

The Commission's experience and industry practice have demonstrated that there are some specific best practices that should be followed, and these best practices are incorporated in an acceptable practice. Specifically, the DCM should have procedures and guidelines for decision-making and implementation of emergency intervention in the market. The DCM should have the authority to liquidate or

transfer open positions in the market,<sup>82</sup> suspend or curtail trading in any contract, require market participants in any contract to meet special margin requirements and allow it to take such market actions as the Commission may direct.

7. Subpart H—Availability of General Information

Core Principle 7 requires that DCMs make available to the public accurate information concerning the contract market's rules and regulations, contracts and operations. The Dodd-Frank Act amended Core Principle 7 by adding a provision requiring the board of trade to make public the rules and specifications describing the operation of the DCM's electronic matching platform or trade execution facility.<sup>83</sup> Since passage of the CFMA, the types of information and the various practices for providing information have become standardized across the industry as DCMs have adopted practices that comply with the current guidance and acceptable practices for Core Principle 7. Accordingly, proposed § 38.401 in subpart H codifies these practices. In addition, the Commission proposes several additional provisions to ensure that pertinent information is available to the Commission, market participants and the public, as described below.

i. Proposed § 38.401(a)—General

Proposed § 38.401(a) requires DCMs to have in place procedures, arrangements and resources for disclosing to market authorities, market participants and the public accurate and relevant information pertaining to: (i) Contract terms and conditions, (ii) rules and regulations applicable to the trading mechanism, and (iii) rules and specifications pertaining to the operation of the electronic matching platform or trade execution facility. Among other types of information, DCMs must ensure that market authorities, market participants and the public have available all material information pertaining to new product listings, new or amended governance, trading and product rules, or other changes to information previously disclosed by the DCM, within the time period prescribed in proposed § 38.401. As described in § 38.401(a) of the regulation, DCMs must provide the required information to market

<sup>81</sup> See CFTC Web site for additional information on the Position Limits rulemaking, at [http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF\\_26\\_PosLimits/index.htm](http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_26_PosLimits/index.htm) (last visited Dec. 14, 2010).

<sup>82</sup> In situations where a swap is traded on more than one platform, emergency action to liquidate or transfer open interest must be directed, or agreed to, by the Commission or Commission staff.

<sup>83</sup> This requirement, while new to the text of Core Principle 7, was previously required as part of former Designation Criteria 4.

participants and the public by posting such information on their Web site, as set forth in proposed § 38.401(c).

ii. Proposed § 38.401(b)—Accuracy Requirement

Proposed § 38.401(b) requires that each DCM have procedures in place to ensure that any information or communication with the Commission is accurate and complete, and further that no false or misleading information is submitted and that no material information is omitted. Similarly, each DCM must have procedures in place to ensure the accuracy and completeness of any information made available to market participants and the public, including information that is made available on its Web site.

iii. Proposed § 38.401(c)—Notice of Regulatory Submissions

The Commission historically has required DCMs to update their rulebooks upon the effectiveness of a rule amendment, product listing or rule certification that has been filed with the Commission. While proposed § 38.401(c) maintains the general requirement for posting rules in the DCM rulebook upon their effectiveness, the Commission believes that market participants and the public would benefit from notifications of proposed rule amendments, product listing (or delistings) and rule certifications in advance of their taking effect.<sup>84</sup> Accordingly, proposed § 38.401(c) requires each DCM to post on its Web site all rule filings and submissions that it makes to the Secretary of the Commission. This information should be posted on the DCM's Web site on the same day that such information is transmitted to the Commission. Where applicable, the DCM Web site should make clear that the posted submissions are pending before the Commission. For example, a DCM's Web site may contain a separate Web page for "regulatory filings" or "rule certifications" for posting submissions or certifications pertaining to new product listings, new rules, rule amendments or changes to previously-disclosed information. This requirement will provide market participants with advance notice of rule amendments and certifications, consistent with the goal of Core Principle 7 to make pertinent information available to market participants and the public. This posting requirement is in addition to the

obligation of DCMs to update their Rulebooks upon the effectiveness of a rule submission or certification.

To the extent that a DCM requests confidential treatment of certain information filed or submitted to the Commission, the proposed rule requires the DCM to post the public portions of the filing or submission.

iv. Proposed § 38.401(d)—Rulebook

As noted above, consistent with the current acceptable practices for Core Principle 7, all DCMs must post and routinely update their rulebooks, which appear on their Web sites. Currently, each DCM updates its rulebook the day that a new product is listed or a new or amended rule takes effect. The vast majority of DCM Web sites also are readily accessible to the public and the information is available by visitors to the Web site without requiring registration, log-in, or user name or password. Proposed § 38.401(d) merely codifies these existing practices.<sup>85</sup>

8. Subpart I—Daily Publication of Trading Information

Core Principle 8 requires that DCMs make available to the public accurate information on settlement prices, volume, open interest, and opening and closing ranges for actively traded contracts on the contract market. The Dodd-Frank Act did not amend Core Principle 8. Accordingly, in proposed § 38.451, the Commission reiterates the current acceptable practice that requires mandatory compliance with § 16.01, "Trading volume, open contracts, prices and critical dates."

However, in order to conform to the Dodd-Frank Act, certain changes were made to § 16.01 regarding the information a reporting market will record and publish on futures and options contracts, and on swap and swaption contracts.

Specifically, the Commission proposes to amend § 16.01(d) to require reporting markets to report information in paragraphs (a)(1) through (6) of § 16.01. Prior to the enactment of the Dodd-Frank Act, reporting markets were required only to report separately the following information enumerated in paragraphs (a)(1) through (5) of current § 16.01 for futures and options: The option delta, where delta system is used, total gross open contracts, excluding from futures those contracts against which notices have been stopped; for futures, open contracts

against which delivery notices have been stopped on that business day; the total volume of trading, excluding transfer trades or office trades; and the total volume of futures exchanged for commodities or for derivatives positions that are included in the total volume of trading.

The Commission proposes to require reporting markets to also report to the Commission the information found in paragraph (a)(6) that is "the total volume of block trades that are included in the total volume of trading." Previously such information was only required to be reported to the public but not separately to the Commission. The Commission believes that having block trade volumes reported separately to it would be useful, particularly in analyzing whether a contract market is in compliance with Core Principle 9 (Execution of Transactions). Because reporting markets currently are required to make block trade volumes available to the public, it should not be an unreasonable burden for the reporting market to submit that information separately to the Commission.

Under the Dodd-Frank Act, DCMs are able to list and trade swaps. Accordingly, amendments to part 16 specify the type of information that DCMs or SEFs must publish daily regarding the swaps contracts traded. Specifically, DCMs and SEFs would be required to publish for their swaps contracts all the information included in proposed § 16.01 (a) (1) through (6) for each trading day for each swap, class of swaps, swaption or class of swaptions as appropriate. For swap contracts that are standard-sized contracts (i.e., contracts that have a set contract size for all contracts), volume and open interest for swaps and swaptions shall be reported in terms of number of contracts traded, just as futures contracts currently are reported. For swap contracts that are non-standard-sized contracts (i.e., contracts whose contract size can vary for each transaction) the volume and open interest should be reported in terms of total notional value traded for that trading day. In addition, § 16.01(b) is amended to require each DCM or SEF to publish for each trading day, by commodity and contract month or by tenor of the swap, the opening price, high price, low price and settlement price of the swap or swaption contract. The Commission is seeking comments on end-of-day price reporting for swaps. Specifically, the Commission seeks comments on the following issues:

- For interest rate swaps, because the tenor on an interest rate swap can be one of thousands of possible periods, what would be an appropriate manner

<sup>84</sup> This is especially relevant when the Commission determines to stay the certification of a DCM submission, as provided by the Dodd-Frank Act, for a 90-day review period, thereby triggering a public comment period.

<sup>85</sup> As noted above, the requirement to maintain an accurate and updated rulebook does not relieve DCMs of their obligations under paragraph (c) to post on their Web sites all rule filings and submissions submitted to the Commission.



to display end-of-day prices for each interest rate swap?

- Would certain end-of-day swap price reporting be more meaningful than others? If so, which methods of price reporting would be more meaningful and why?
- Would certain end-of-day swap price reporting be misleading? If so, which methods of price reporting would be misleading and why?

#### 9. Subpart J—Execution of Transactions

The Dodd-Frank Act amended Core Principle 9 to require, among other things, that a board of trade must provide a competitive, open and efficient market and mechanism for executing transactions “that protects the price discovery process of trading in the centralized market of the board of trade.”<sup>86</sup> The amended core principle also provides that off exchange transactions are permitted for bona fide business purposes if authorized by the board of trade’s rules.<sup>87</sup>

In assessing a DCM’s initial and ongoing compliance with Core Principle 9, the Commission currently considers several criteria, including, among others, the methodology and mechanisms of the DCM’s trading system to ensure fair and orderly trading and the rules the DCM may have for permissible transactions executed off the centralized market. In so doing, the Commission has looked at § 1.38 of the Commission’s regulations, which sets forth a requirement that all purchases and sales of a commodity for future delivery or a commodity option on or subject to the rules of a DCM should be executed by open and competitive methods. There is an exception to this “open and competitive” requirement if the transaction is in compliance with the rules of the DCM that specifically provide for the non-competitive execution of such transactions.<sup>88</sup> In addition, the current guidance for Core

Principle 9 provides that a competitive, open and efficient market and mechanism for execution of transactions includes: (1) The DCM’s methodology for entering orders and executing transactions; (2) that appropriate objective testing and review of automated systems should occur initially and periodically to ensure proper system functioning, adequate capacity and security; and (3) that a DCM that determines to allow block trades should ensure that such trades do not operate in a manner that compromises the integrity of prices or price discovery in the relevant market.<sup>89</sup>

In light of the Dodd-Frank Act amendments to Core Principle 9 and the Commission’s experience in implementing Core Principle 9 since enactment of the CFMA, the Commission proposes to adopt certain regulations in subpart J of the Commission’s regulations to establish requirements that a DCM must meet in order to comply with amended Core Principle 9. Specifically, new regulations are proposed to clarify the amended core principle’s mandate requiring the protection of the price discovery function of trading on a DCM’s centralized market. Other regulations codify practices that have become standard and adopted over the years by the industry. In addition, the Commission re-proposes certain guidance and acceptable practices that were published by the Commission in the September 2008 Notice of Proposed Rulemaking pertaining to “Execution of Transactions: Regulation 1.38 and Guidance on Core Principle 9”<sup>90</sup> (hereafter “2008 Core Principle 9 Proposed Rulemaking”) for purposes of informing DCMs of how they may comply with certain other aspects of amended Core Principle 9.<sup>91</sup>

<sup>89</sup> The current acceptable practice for Core Principle 9 identifies an example of the type of party that would be an acceptable party to carry out the testing and review of an electronic trading system. The Commission notes that under its proposed rulemaking, all rules relating to the type of testing and review required for trading systems would be set forth under new Core Principle 20, System Safeguards, discussed infra at Section II.D.20.

<sup>90</sup> 73 FR 54097, Sep. 18, 2008. That proposed rulemaking was a re-proposal of some rules, guidance and acceptable practices pertaining to Regulation 1.38 and Core Principle 9, initially proposed on July 1, 2004. See 69 FR 39880, July 1, 2004. There were no final rulemakings to either of these proposals.

<sup>91</sup> In 2009, before those proposed rules were finalized, Congress initiated the legislative process that culminated in the Dodd-Frank Act. Accordingly, a number of the proposed rules contained in this release consist of regulations that were initially proposed in the 2008 Core Principle 9 Proposed Rulemaking, with relevant updates.

In short, the Commission proposes to adopt the following regulations, guidance and acceptable practices for Core Principle 9, as amended by the Dodd-Frank Act:

- New § 38.501 proposes to codify in part 38 the requirements that are currently contained in § 1.38 of the Commission’s regulations, with amendments that were initially proposed in the 2008 Core Principle 9 Proposed Rulemaking along with relevant updates. Section 1.38 of the Commission’s regulations would be eliminated.
- New § 38.502 addresses the specific requirements associated with protecting the price discovery function of trading on a DCM’s centralized market as now specifically imposed by the Dodd-Frank Act. The proposed rule imposes: (i) Minimum requirements for trading on the centralized market for contracts listed on DCMs, (ii) mandatory delisting of contracts if the requirements of trading are not met, (iii) specified procedures for treatment of contracts existing prior to the effective date of this section, and (iv) limited exemptions for certain contracts that the Commission, upon a petition of the DCM, permits to remain listed under specified circumstances.

- New §§ 38.503 and 38.504 propose to codify certain requirements for block trades for futures and swaps and § 38.505 addresses other off-exchange transactions. These provisions codify practices that Commission staff has previously required and that have become industry practices. In particular, these proposed rules set forth block trade requirements for futures contracts and options, including who may enter into block trade transactions, conditions for block trades between affiliated parties, aggregation, recordkeeping and reporting procedures. In addition, in proposed § 38.505, the Commission proposes to adopt rules for off-exchange transactions that involve exchange of derivatives for related position, specifically describing what constitutes a bona fide trade and reporting requirements for such trades. Proposed § 38.504 addresses certain block trading requirements specifically for swaps traded on the DCM, and proposed § 38.506 addresses transfer and office trades.

- A new acceptable practice would provide a safe harbor methodology for DCMs to follow in determining the minimum size of block transactions for individual contracts. The acceptable practice also would provide a safe harbor relating to the manner of pricing block trades. By proposing this acceptable practice the Commission

<sup>86</sup> 7 U.S.C. 7; see also Section 5(d)(9) of the CEA, as amended by the Dodd-Frank Act.

<sup>87</sup> This language was taken from former Designation Criterion 3.

<sup>88</sup> The Commission notes that the CFMA, which was enacted after promulgation of § 1.38, modified Section 3 of the current CEA to require that transactions subject to the CEA provide “a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities.” The CFMA also specifically listed some of the types of transactions that could be executed off the centralized market, including exchange of futures for swaps, and allowing a futures commission merchant, acting as principal or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if the contract is reported, recorded, or cleared in accordance with the rules of a contract market or derivatives clearing organization. 7 U.S.C. 7(b)(3).

recognizes the need for flexibility as the appropriate minimum size and pricing of block trades vary among contracts and across DCMs.

i. Proposed § 38.501—General Requirements

Current § 1.38 of the Commission's regulations requires, subject to certain exceptions, "that all purchases and sales of a commodity for future delivery, and of any commodity option, on or subject to the rules of a DCM shall be executed openly and competitively by open outcry or posting of bids and offers or by other equally open and competitive methods \* \* \* provided, however, that this requirement shall not apply to transactions that are executed noncompetitively in accordance with written rules of the contract market \* \* \*"<sup>92</sup> The 2008 Core Principle 9 Proposed Rulemaking proposed certain revisions to § 1.38. Specifically, in addition to simplifying the language, the 2008 Core Principle 9 Proposed Rulemaking proposed to update the language of § 1.38 to more accurately identify the types of transactions that may be executed off a contract market's centralized market under the rules of a DCM.<sup>93</sup> The 2008 Core Principle 9 Proposed Rulemaking also would make it clear that under § 1.38, DCMs may self-certify (not just seek approval for) rules or rule amendments related to transactions off the centralized marketplace. Both of these changes were proposed to the language of regulation § 1.38 to incorporate updates made to the CEA in 2000 by the CFMA.

As noted above, the existing provisions of current § 1.38 will be incorporated in proposed § 38.501, including previously proposed amendments, with some updates. These updates include language that adds to the types of transactions that may be executed off of a DCM's centralized market. In addition, the proposed rule replaces the term "exchange of futures for commodities or for derivatives positions" with the term "exchange of derivatives for a related position." This term is more descriptive of the panoply of off-exchange transactions currently offered by DCMs, including exchange for physicals, exchange for swaps, exchange for risk or exchange of futures

for futures. This term also will encompass other types of off-exchange transactions, not limited to futures. Finally, because swaps may now be traded on DCMs, the proposed rule will reference swaps.

ii. Proposed § 38.502—Minimum Centralized Market Trading Requirement

As noted, the Dodd-Frank Act amended Core Principle 9 to specifically require that in the execution of transactions, "the price discovery function of trading in the centralized market" must be protected.<sup>94</sup> The amended core principle recognizes that trading in the centralized market provides a price discovery function, and specifically requires that the execution of transactions be in a manner that protects that price discovery process.

The Commission notes that, under the current regulatory landscape, some DCMs have listed contracts for the purpose of providing a clearing solution for privately negotiated bi-lateral swap trades or trades made on exempt commercial markets. The DCMs accept these trades as futures contracts by converting them, through their block trade or exchange-for-swaps (or other exchange of derivatives for a related position) rules, to economically equivalent futures contracts in order for them to be cleared by their derivatives clearing organization. The vast majority of those contracts are not executed openly or competitively on the centralized market, but rather are effected away from the DCM's centralized market.<sup>95</sup> Despite the lack of trading on the centralized market these

contracts still manage to achieve open interest over sustained periods of time.

A DCM that trades contracts that have a disproportionate percentage of their trading volume attributable to off-exchange activity and little or no open and competitive, centralized market trading would not appear to be in compliance with amended Core Principle 9. Specifically, where all or most transactions in a DCM contract are executed off the centralized market, there is no price discovery taking place on the DCM such that the protection of the price discovery process of trading in the centralized market is not satisfied.

The Commission notes that, while amended Core Principle 9 recognizes the primacy of trading on the centralized market for price discovery, it does not bar off exchange transactions. Congress reaffirmed that the rules of the DCM may authorize bona fide off-exchange transactions. Thus, in implementing the provisions of the Dodd-Frank Act, the Commission seeks to protect the price discovery process of trading on the DCM's centralized market while permitting DCMs to authorize off-exchange transactions where necessary and appropriate for bona fide business purposes. Accordingly, the Commission's proposal provides for permissible off-exchange transactions, but only to the extent that such transactions do not compromise the price discovery process of trading in the centralized market. If off-exchange transactions become the exclusive or predominant method of establishing or offsetting positions in a particular market, the price discovery process in the centralized market will be jeopardized.

a. Minimum Centralized Market Trading Percentage Requirement

The Commission believes that a significant amount of trading in any contract listed on a DCM must occur on the centralized market in order to meet the requirements of Core Principle 9. The Commission believes that setting a minimum percentage of trading that must take place on the centralized market is an appropriate method of implementing this provision in order to provide clarity and legal certainty to DCMs. Accordingly, the Commission is proposing to establish a minimum on-exchange trading threshold of 85 percent.

In considering the minimum threshold of trading on the centralized market, the Commission reviewed data regarding the amount of off-exchange transactions in 570 listed DCM

<sup>94</sup> 7 U.S.C. 7; see also section 5(d)(9) of the CEA, as amended by the Dodd-Frank Act.

<sup>95</sup> Under current CEA section 4d(a)(2), funds supporting customer trades executed on a designated contract market must be segregated from other funds, including proprietary funds, of a future commission merchant ("FCM") or clearinghouse. Customers often desire to commingle funds in this segregated account primarily to take advantage of lower margins due to off-setting positions. Current CEA section 4d(a)(2) provides a venue for achieving this by allowing the Commission to issue orders exempting an FCM or clearinghouse from the segregation requirement in appropriate situations. The DCM must go through the process of petitioning the Commission for an exemption, and providing the necessary information and data for the Commission to make a decision. The Commission's process for issuing Section 4d orders necessarily entails careful and measured review, and accordingly, can be time-intensive. The Commission believes that rather than seeking 4d orders for off-exchange products, certain DCMs have resorted to listing those products as futures despite their unlikely prospects for central marketplace trading, to achieve the same results as the Section 4d process to the possible detriment of the centralized market. See also, section 4d(a)(2) of the CEA, as amended by the Dodd-Frank Act.

<sup>92</sup> 17 CFR 1.38 (2009).

<sup>93</sup> The proposed language for § 1.38(b)(1) identified "transfer trades, office trades, block trades, inter-exchange spread transactions, or trades involving the exchange of futures for commodities or for derivatives positions, if transacted in accordance with written rules of a contract market that provide for execution away from the centralized market and that have been certified to or approved by the Commission." This release proposes updates to this list.

contracts.<sup>96</sup> Those contracts represented actively traded futures products on eight DCMs and included a wide cross-section of products with open interest. The data illustrated that the trading volume in the 570 contracts could be grouped into two main categories.<sup>97</sup> In one category, involving 410 of the contracts, mostly involving energy, forex and weather contracts, almost all or all of the trading over a three month period occurred off-exchange. As noted above, the Commission believes that the price discovery process in the centralized market is jeopardized where off-exchange transactions become the exclusive or predominant method of establishing or offsetting positions in a particular market. Since there was no centralized market trading in those contracts, the Commission did not consider these 410 contracts in its analysis of the appropriate minimum centralized market trading requirement. In the second largest category, involving 128 contracts from all asset classes which included contracts with large and small open interest, the average amount of off-exchange trading over the three-month period ranged from 0% to 15%. The Commission believes that this second category of contracts, where there was actual centralized market trading to observe, provides a reasonable basis for establishing a minimum centralized market trading requirement. Accordingly, from this second category the Commission took the upper range of the maximum average amount of off-exchange trading, and proposes that a maximum of 15%

<sup>96</sup> Commission staff collected data on the amount of off-exchange trading that took place over the three month period from May 2010 through July 2010, for 570 contracts listed on eight designated contract markets (CME, CBOT, NYMEX, COMEX, ICEUS, One Chicago, Kansas City Board of Trade and the Minneapolis Grain Exchange) and covering 10 asset classes (agricultural, alternative markets (i.e., environmental products), currency, energy, financial, index, interest rates, metal, real estate and weather). In collecting data, Commission staff attempted to sample a cross-section of trading data from the eight DCMs. The data collected represents samples of: (i) Active contracts in the main asset classes (financials, energy, agricultural, index, currency, weather, real estate, and metals); (ii) particular contracts that historically have not traded on the centralized market (i.e., certain energy contracts, currency); (iii) commodities that as a group trade differently from other commodities (i.e., cocoa, coffee); (iv) commodities that are prominent on certain exchanges (i.e., wheat on the Kansas City Board of Trade and the Minneapolis Grain Exchange), (v) "softs" and (vi) other products on ICE Futures U.S. Commission staff began collecting data in early August 2010 for the period May 2010 through July 2010. This time period was chosen because it represented the most current and straightforward data available at the time Commission staff began collecting data.

<sup>97</sup> A third category, consisting of a small number of contracts with trading volume between 15–60%, is discussed further below.

of total trading volume of a contract would be an allowable amount of off-exchange trading in order to protect the price discovery process of trading on the centralized market.

The Commission believes that requiring at least 85% of a contract's volume to be traded on the centralized market will balance the goal of protecting the price discovery process of trading in the centralized market, with the goal of allowing off-exchange transactions for bona fide business purposes. The Commission invites comments on the minimum centralized market trading percentage requirement proposed herein. In particular, the Commission requests that commenters providing alternative percentage requirements or alternative approaches also provide data that supports any alternative percentage or other approach.

#### b. Centralized Market Trading Percentage Calculation

In order to determine the percentage of on and off exchange trading in a contract, DCMs must measure the average percentage of trading in each contract over a sufficient period of time. Indeed, the data collected by the Commission indicates that for those contracts that have significant trading on the centralized market, the amount of off-exchange trading varies from day to day. The Commission proposes that a reasonable time period over which to measure and determine a contract's on-exchange trading volume is 12 months.

Thus, for new contracts listed after the effective date of the minimum centralized market trading percentage requirement in 38.502(a), the Commission proposes that DCMs determine the amount of on-exchange trading in each contract at the conclusion of the 12 month period following the contract's initial listing on the exchange, and again on every 12 month anniversary going forward. The designated contract market must calculate the centralized market trading percentage for each listed contract within thirty days following the conclusion of the 12 month anniversary of each contract's listing. The Commission notes that in order to be in compliance with Core Principle 9, the DCM has the burden of reviewing the on and off-exchange trading for each of its contracts over the relevant period to determine whether it is subject to delisting. The Commission notes that as part of its oversight, it also will be reviewing trading data of contracts. For contracts and contract months listed prior to the effective date of § 38.502(a), the Commission proposes that the DCM

must initially calculate the centralized market trading percentage in each of its contracts within thirty days of the effective date of this minimum centralized market trading rule. The initial calculation for each existing contract must be based on the trading volume in the contract during the 12 month period immediately preceding the effective date of this rule.<sup>98</sup> Thereafter, the DCM must calculate the centralized market trading percentage in each such contract within thirty days of the 12 month anniversary of the initial calculation.

#### c. Mandatory Delisting

As noted above, the minimum centralized market trading requirement would permit DCMs to list only those contracts that have a minimum average over a 12 month period of 85% trading on the centralized market. Accordingly, subject to the relief provided for existing contracts and the other limited exemptions noted in paragraphs (d) and (e) of proposed § 38.502 below, proposed § 38.502(c) requires that for those contracts that do not meet the minimum centralized market trading percentage requirement, the DCM has the following options, which it must effectuate within ninety days of the centralized market trading percentage calculation: (i) If the DCM operates a SEF, it can delist the swap contract from the DCM and transfer open swap positions to the SEF; (ii) the DCM can transfer the swap contract(s) to another SEF that accepts the contract; or (iii) the DCM can trade the contract on the DCM for liquidation purposes only.

The Commission notes that contracts that may be required to be delisted have a potential alternative venue as Congress created, in the Dodd-Frank Act, the SEF,<sup>99</sup> a new trading facility for the trading, processing and execution of swaps.<sup>100</sup> Among other requirements,

<sup>98</sup> As noted in the discussion under subpart J of this release, if a contract has been listed for less than a 12 month period, the Commission proposes that a DCM may seek an exemption as to that contract(s) and obtain a maximum of 12 additional months to calculate its centralized market trading for that contract(s).

<sup>99</sup> The SEF Core Principles, under Section 5h of the CEA, as amended by the Dodd-Frank Act, do not include a counterpart to the DCM Core Principle 9 requirement to protect the "price discovery process of trading in the centralized market of the board of trade."

<sup>100</sup> The Commission notes that based upon a letter sent to Chairman Gensler from the Wholesale Markets Brokers' Association ("WMBA"), the Commission understands that many of the participants that currently facilitate the privately negotiated contracts that are listed, but not traded, on a designated contract market intend to establish SEFs, confirming that this is an appropriate alternative forum for such contracts. The

the Dodd-Frank Act requires SEFs to facilitate the clearing and settlement of swaps.<sup>101</sup> Accordingly, parties seeking clearing and segregated account status for swaps may achieve these objectives on a SEF.<sup>102</sup> The Commission invites comments as to these proposals.

d. Treatment of Contracts Listed as of the Effective Date of This Section

Proposed § 38.502(d) provides relief from the provisions of § 38.502(c) for contracts listed on a DCM as of the effective date of this section. The Commission understands that many contracts and contract months listed on a DCM before the effective date of the proposed rule may not meet the proposed minimum centralized market trading percentage requirement and, therefore, would be subject to mandatory delisting upon the effective date of the rules in this section ("affected contracts"). The Commission also notes that delisting a large number of these affected contracts within a short period of time may be difficult and result in potential financial consequences. Accordingly, the Commission proposes a transition process for the affected contracts to be liquidated in a fair and orderly manner. Specifically, the Commission proposes in § 38.502(d) that affected contracts that do not meet the minimum

Commission, however, takes notice of the fact that the WMBA also proposes a much broader reading of Core Principle 9 contending, among other things, that the requirements of Core Principle 9 apply only to transactions that are traded on a DCM and not to transactions, such as exchanges of futures for swaps, that are submitted in compliance with DCM rules; that the Commission should consider other execution models that are competitive open and efficient; that compliance with Core Principle 9 does not require that all trades submitted to a DCM be executed on the DCM's proprietary electronic trading network; and that Core Principle 9 should not be applied in the same way to futures, which may be traded by retail investors, as it may be applied to OTC products that are only eligible to be traded by Eligible Contract Participants. Letter to Chairman Gary Gensler from WMBA dated September 10, 2010.

<sup>101</sup> CEA Section 5h(f)(7), as amended by the Dodd-Frank Act. In addition, this requirement accommodates the creation of Cleared Swaps Customer Collateral account with bankruptcy protection. Additionally, the Commission may permit the netting of futures and swaps within such account. See CEA Section 4d(f)(3)(B), as amended by the Dodd-Frank Act.

<sup>102</sup> The Commission notes that swaps cleared through an FCM and associated collateral are protected in bankruptcy as commodity contracts. See section 724(b) of the Dodd-Frank Act (to be codified at 11 U.S.C. 761(4)(F)). Moreover, to achieve benefits of portfolio margining, a designated contract market may still petition for an order pursuant to section 4d(a)(2) of the CEA to permit such swap transactions to be commingled in the segregated customer account for exchange traded transactions, or an order pursuant to CEA section 4d(f)(3)(B) to permit related exchange traded futures transactions to be commingled in the segregated customer account for swaps.

centralized market trading requirement may continue to be listed on the DCM until all open positions in such contracts and contract months are closed or liquidated. Trading in such contracts will be allowed but only to close or liquidate a position.<sup>103</sup>

In essence then, after the effective date of the proposed rules in this section, affected contracts that are listed before the effective date of this rule and that do not meet the minimum centralized market trading requirement will not be required to delist or liquidate within 90 days as required by the proposed rule. Instead, all affected contracts will be allowed to continue to be listed, and either traded on the DCM for liquidation purposes only, through offsetting trades, or held until settlement at contract expiration. These affected contracts would, therefore, either close out at contract expiration or when open interest in the contract reaches zero. For any affected contracts that may not have been listed and traded for a full 12 month period on the effective date of the proposed rule, proposed § 38.502(e) proposes additional relief, as described below.

The Commission points out that with respect to this transition period, trades in the affected contracts must comply with the provisions of Section 2(h)(8) of the CEA, as amended by the Dodd-Frank Act, once effective. Thus, while a DCM will be allowed to continue to list and trade in its existing contracts for purposes of liquidating respective futures positions, upon the effective date of amended CEA Section 2(h)(8), the closing out of that position with an associated swaps position must be accomplished in compliance with the requirements of amended CEA Section 2(h)(8). To that end, such swaps positions can only be executed on a SEF or DCM, or with a bilateral off-exchange trade either as a block trade, or where the trade is exempt from the provisions of amended CEA Section 2(h)(8) because one party to the trade includes an end user.<sup>104</sup>

The Commission invites comments on its proposal and also invites alternative proposals on how to address those DCM contracts listed prior to the effective date of these rules.

<sup>103</sup> It is possible that a trader may not desire to close out a position. Since the position is carried at the clearing house, a trader may instead decide to keep the position in the clearing house until expiration. Traders with existing positions as of the effective date of the rules in this section will be permitted to maintain these positions in the respective margin account.

<sup>104</sup> See generally, section 2(h) of the CEA, as amended by the Dodd-Frank Act.

e. Exemption Upon Petition

As noted above, the data collected by the Commission illustrates a category of contracts that experienced an average off-exchange trading volume greater than 15% but less than 100% over the three month period. The Commission recognizes that there are contracts that may experience off-exchange trading averages that are above the proposed 15% maximum off-exchange trading and that circumstances surrounding those contracts may warrant an exemption from the minimum centralized market trading percentage requirement. For example, there may be situations where a newly-listed contract initially may have little on-exchange trading, and may fail to meet the minimum centralized market trading requirement for the initial 12 month period despite experiencing a steady increase in trading volume over time. In those situations, it may be appropriate to provide the DCM with an opportunity to petition for an exemption to this requirement for a maximum of a 12 month period. Proposed § 38.502(e)(1) reflects such an exemption.

In order to promote legitimate petitions, the proposed rule specifically provides that the DCM must demonstrate in its petition that such contract has achieved an average of at least 50% trading volume on the centralized market over the preceding 12 month period, and also must make an adequate showing that the contract, if granted the exception, is likely to attain the minimum trading requirement within the following 12 month period. The Commission also recognizes that some affected contracts that are listed as of the effective date of the proposed rule may not have been listed and traded for a full 12 month period at such time, potentially requiring the DCM to calculate the contract's on-exchange trading based on some shorter period of time. In those situations, the Commission believes it is only fair to allow such contracts additional time, if desired, to determine whether the minimum centralized market trading percentage requirement is met. As such, the Commission proposes in § 38.502(e)(2) to allow a DCM in this situation to petition the Commission to exempt a contract from the requirements of proposed § 38.502(d) for a maximum period of 12 months. Under proposed § 38.502(e)(3) petitions seeking an exemption from the mandatory delisting requirement in § 38.502(c) must be submitted to the Commission within thirty-five days of the 12 month anniversary of the listing of such contract, or for affected contracts

seeking an exemption because they have been listed for less than 12 months, thirty-five days after the effective date of this section. The filing of a petition shall toll the mandatory delisting requirement until such time that a decision is made. The Commission invites comments on all aspects of this proposed rule.

We specifically request comment on how the proposals related to the requirement that 85 percent or greater of volume of a contract must be traded on the DCM's centralized market will affect the ability of market participants to take advantage of efficiencies like portfolio margining for swaps and futures positions. We also request comment on any negative consequences this proposal may have on the trading of swaps and related transactions like exchange of futures for swaps? The Commission also is requesting comments on whether any other exemptions should be considered for contracts that do not meet the minimum centralized market trading percentage threshold of on-exchange trading volume but nevertheless appear to serve a price discovery function, and what factors should be considered in making the exemption determination. For example, would it be acceptable for a contract market to provide evidence of the frequency to which cash market bids, offers or transactions in a commodity are directly based on, or are determined by referencing the prices generated by trading the subject contract on the designated contract market? Finally, the Commission also requests comments, with supporting information, on whether the Commission should consider any other exemptions from proposed § 38.502.

### iii. Proposed § 38.503—Block Trades on Futures Contracts

As noted above, in addition to updates to § 1.38, the 2008 Core Principle 9 Proposed Rulemaking<sup>105</sup> proposed revised guidance and acceptable practices relating to block transactions for futures and options. The Commission proposes to codify some of the provisions in the guidance and acceptable practices relating to block trading that are, to a large degree, already current industry practice. The Commission believes that codifying these block trading requirements will result in greater regulatory certainty and consistency for DCMs. As discussed below, the Commission proposes, however, to maintain guidance and acceptable practices with respect to a

DCM's determination of block sizes and block pricing for futures contracts, as it is expected that the determination of block sizes and pricing will evolve as both the industry and the Commission continue to gain experience in this area.

Consistent with the requirements set forth in current § 1.38 and amended Core Principle 9, proposed § 38.503(a) would require that a board of trade that permits block trade transactions on futures contracts must have rules governing such transactions. As proposed in the 2008 Core Principle 9 Proposed Rulemaking, this regulation will require that the rules limit block trades to large transactions and impose minimum size requirements. The proposed rule also states that the block trade size must be certified or approved by the Commission.

The Commission recognizes that the minimum size thresholds for block trades in a contract may change over time due to changes in sizes of trades in the centralized market and the market's volume and liquidity. Accordingly, proposed § 38.503(b) proposes that block trade size must be reviewed on an annual basis. Any necessary adjustments must be made to new and existing contracts.

Proposed § 38.503(c) codifies the 2008 Core Principle 9 Proposed Rulemaking proposal to limit block trade parties for futures, options and swaps to eligible contract participants ("ECPs") as that term is defined in Section 1a(18) of the CEA, as amended by the Dodd-Frank Act. However, the rule makes clear that commodity trading advisors acting in an asset managerial capacity and investment advisors that have over \$25 million in assets under management, including foreign persons performing equivalent roles, are allowed to carry out block trades for non-ECP customers. The proposed rule also prohibits any person from conducting a block trade on behalf of a customer, unless the person receives instruction or prior consent to do so from the customer.<sup>106</sup>

Proposed § 38.503(d) codifies the concepts in the 2008 Core Principle 9 Proposed Rulemaking with respect to affiliated parties for futures, options on futures and options on commodities. The proposed rule defines an "affiliated party," for purposes of block trades on futures, as a party that directly or indirectly through one or more persons, controls, is controlled by, or is under

common control with another party. As noted in the 2008 Core Principle 9 Proposed Rulemaking, appropriate safeguards are important for block trades between affiliated parties, because transactions between two closely related parties are more susceptible to abuse, such as setting unreasonable prices, artificially boosting volume, money passing, or wash trading. This is because it is possible that two related parties are not motivated by their own separate interests, but by the interests of a person or entity that may control both of the parties. Thus, under proposed § 38.502(d)(3), block trades can take place between affiliated parties under the following conditions: (i) The block trade prices must be based on a competitive market price, either by falling within the contemporaneous bid/ask spread on the centralized market or calculated based on a contemporaneous market price in a related cash market; (ii) each party must have a separate and independent bona fide business purpose for engaging in the trades; and (iii) each party's decision to enter into the block trade must be made by a separate and independent decision-maker. As noted in the 2008 Core Principle 9 Proposed Rulemaking, the Commission believes that the proposed rules for block trades between affiliated parties strike an appropriate balance between allowing such trades and ensuring that each party is acting independently when it agrees to enter into such a transaction.

Proposed § 38.503(e) codifies the practices proposed in the 2008 Core Principle 9 Proposed Rulemaking relating to aggregation of orders. The proposed rule prohibits aggregation of orders for different trading accounts in order to satisfy the minimum block size requirement, except if done by a commodity trading advisor acting in an asset manager capacity or an investment advisor who has \$25 million in total assets under management.

Proposed § 38.503(f) and (g) set forth the requirements for recordkeeping and reporting of block trades for futures and options. As to recordkeeping, proposed § 38.502(f) reflects the provisions contained in § 1.38(b) with certain updates. Thus, as is the current requirement, persons handling, executing, clearing, or carrying transactions off the centralized market must follow the rules of the DCM, including providing the appropriate identification of such transactions to the DCM. In addition, the proposed rule codifies the concept initially proposed in the 2008 Core Principle 9 Proposed Rulemaking that the DCM must have rules for keeping appropriate records.

<sup>105</sup> The Commission first proposed amendments to section 1.38 and guidance with respect to Core Principle 9 in July 2004. See 69 FR 39,880, Jul. 1, 2004.

<sup>106</sup> All of these requirements mirror block trade rules previously approved by the Commission. The Commission approved block trade rules of the Cantor Financial Futures Exchange, Inc. on February 11, 2000; the Commission also approved Chicago Mercantile Exchange block trade rules on May 19, 2000.

Proposed § 38.503(f) requires that parties to, and members facilitating, block trades keep accurate block trade records that comply with Core Principles 10 and 18 and the associated regulations.<sup>107</sup> The proposed rule also requires that block trade orders and records must be accessible to the DCM, the Commission or the Department of Justice, upon request.

Proposed § 38.503(g) reflects a revised approach from the 2008 Core Principle 9 Proposed Rulemaking pertaining to the reporting of block trades. While the 2008 Core Principle 9 Proposed Rulemaking proposed that block trades be reported to the contract market within a reasonable time, proposed § 38.503(g) codifies the practice already enforced by a great majority of DCMs by requiring that DCMs have up to 5<sup>108</sup> minutes to report block trades.<sup>109</sup> The Commission believes that this is an appropriate amount of time for reporting block trades and balances the goals of providing transparency while enabling market participants involved in block trades with time to hedge risks associated with such trades. The Commission seeks comments as to whether this is an appropriate time period or whether and why another time period is more appropriate.

In addition, proposed § 38.503(g) requires DCMs to publicize the details on block trades immediately upon the receipt of the transaction report, and to publicize daily the total quantity of the block trades that are included in the total volume of trading under the procedures set forth in § 16.01.

Proposed § 38.503(h) refers applicants and DCMs to the guidance in Appendix B to part 38 for purposes of determining block size and pricing determinations. As noted above, the Commission is proposing amended guidance and acceptable practices in Appendix B of part 38 pertaining to block size and block pricing. The Commission believes that a one-size fits all approach to determining block size and pricing is inappropriate for block trades as it is expected, as noted above, that the determination of block sizes and pricing

will evolve as both the industry and the Commission continue to gain experience in this area. Accordingly, the Commission is re-proposing, with some changes, the acceptable practices that were proposed in the 2008 Core Principle 9 Proposed Rulemaking regarding establishing an acceptable minimum block size.

The 2008 Core Principle 9 Proposed Rulemaking proposed replacing an earlier-proposed numerical test with the concept that, in establishing requirements for minimum block size, it was more appropriate to utilize a procedural approach that takes into consideration the purposes for allowing blocks and the trading in the particular contract. The 2008 Core Principle 9 Proposed Rulemaking explained that one of the bases for permitting block trades to be transacted off the centralized market is that prices attendant to the execution of large transactions on the centralized market may diverge from prevailing market prices that reflect supply and demand of the commodity. This is because the centralized market may not provide sufficient liquidity to execute large transactions without additional costs that may reflect the cost of executing the trade. Consequently, reporting these prices as conventional market trades would be misleading to the public. As explained in the 2008 Core Principle 9 Proposed Rulemaking, another basis for allowing block trades is that such trades facilitate hedging by providing a means for commercial firms to transact large orders without the need for significant price concessions, and resulting price uncertainty for parties to the transaction that would occur if transacted on the centralized market. Finally, a procedural approach is more appropriate because the size of a typical trade varies between contracts, and is dependent on the liquidity in the centralized market and other commercial factors.

Given these reasons, the Commission previously proposed a standard whereby the minimum block trade sizes should be larger than the size at which a single buy or sell order is customarily able to be filled in its entirety at a single price in that contract's centralized market, and exchanges should determine a fixed minimum number of contracts needed to meet this threshold. The Commission is re-proposing this acceptable practice with some modifications. Specifically, the Commission proposes that block trade sizes should be a number larger than the size at which a single buy or sell order is customarily able to be filled in its entirety without incurring a substantial

price concession. The Commission believes this is a more appropriate threshold because in less liquid markets even a small number of trades could have a slight movement on price and would not present an accurate picture of the market.

In the 2008 Core Principle 9 Proposed Rulemaking, the Commission also proposed, as part of the acceptable practice, certain factors that the DCM could consider in determining the appropriate minimum block size. These factors included the market's volume, liquidity and depth, a review of typical trade sizes and/order sizes and any input it may receive from floor brokers, floor traders and/or market users regarding, for example, what size order is generally too large to fill without major price concessions. The Commission believes that these factors are likely to lead to an appropriate block size and thus proposes them as acceptable practices in this release. In addition, the Commission is proposing that DCMs also take into account, as an additional factor, the block sizes on comparable swap products. This additional factor is necessary and appropriate in light of the inclusion of swap trading and execution on DCMs and SEFs, and the corresponding swap block rules discussed below.

The Commission proposes similar acceptable practices for determining the acceptable minimum size for block trades in new futures contracts and options. However, because a new contract will not have any trading history, the Commission proposes that the acceptable minimum block trade size in such contracts is the trade size that the DCM reasonably anticipates will not be able to be filled in its entirety in the contract's centralized market, without major price concessions. In determining an acceptable block size, the DCM should consider centralized market data in a related futures contract, the same contract traded on another exchange, or trading activity in the underlying cash market. For the reasons discussed above, the DCM should also consider, as an additional factor, the block sizes on comparable swap products.

The Commission also re-proposes in this release the acceptable practices proposed in the 2008 Core Principle 9 Proposed Rulemaking relating to the pricing of blocks. The proposed acceptable practice requires that block trades between non-affiliated parties must be at a fair and reasonable price. The proposed acceptable practices set forth the factors that could be considered by DCMs in determining what is fair and reasonable, including:

<sup>107</sup> An acceptable practice under this regulation is set forth in proposed appendix B of part 38 and provides that records kept in accordance with the requirements of FASB Statement No. 133 ("Accounting for Derivative Instruments and Hedging Activities"), as amended by FASB Statement No. 161 ("Disclosures About Derivative Instruments and Hedging Activities—An amendment of FASB Statement No. 133") are acceptable records.

<sup>108</sup> The Commission notes that for a few contracts with lower liquidity, such as weather and housing, CME allows for a 15 minute reporting time.

<sup>109</sup> See 73 FR 54,097, at note 18, Sep. 18, 2008 (noting CBOT Rule 331.05(d), CMD Rule 526(F); NYMEX Rule 6.21C).

(1) The size of the block, (2) the price and size of other block trades in any relevant markets at the applicable time, and (3) the circumstances of the market or the parties to the block trade. The proposed acceptable practice states that relevant markets include the DCM itself, the underlying cash markets and/or related futures or option markets. As noted in the proposed acceptable practices, if the contract market rule requiring a fair and reasonable price includes the circumstances of the parties or of the market, a block trade participant can execute a block transaction at a price that is away from the market provided that the participant retains documentation to demonstrate that the price was indeed fair and reasonable under the participant's or market's particular circumstances. In addition, the proposed acceptable practices note that block trades between affiliated parties are subject to the pricing requirements in § 38.503(d).

iv. Proposed § 38.504—Block Trades on Swap Contracts

The Dodd-Frank Act amended the CEA to expand the list of products that may be traded on a DCM to include swaps, in addition to futures and options contracts. The Commission recognizes that there exists certain inherent differences between futures and options, on the one hand, and swaps on the other, which may necessitate that DCMs apply different rules to these products. While the Commission generally believes that the same block trade rules should apply to futures, options and swaps listed and traded on the DCM, the Commission proposes that characteristics of swaps do warrant a different approach for purposes of determining minimum block size. In addition, the Dodd-Frank Act provides specific statutory requirements for reporting of swap block transactions. The rules governing each of these requirements are currently being addressed in a forthcoming Commission release titled "Real Time Reporting," which is proposing rules that will be codified in part 43 of the Commission's regulations.<sup>110</sup> Accordingly, DCMs must comply with the provisions of proposed part 43 for purposes of setting the minimum size of swap block trades, and for reporting swap block trades. Proposed § 38.504 provides that DCMs must have rules that require compliance with these rules for swaps traded on their markets.

v. Proposed § 38.505—Exchange of Derivatives for Related Position

In the 2008 Core Principle 9 Proposed Rulemaking, the Commission proposed acceptable practices relating to exchange of futures for related position transactions. The acceptable practices proposed in that rulemaking were based on previous publications by the Commission, including the 1987 EFP Report prepared by the Commission's then-Division of Trading and Markets and the Commission's 1998 EFP Concept Release.<sup>111</sup> Proposed § 38.505 codifies the practices that the Commission historically has required from DCMs with respect to these types of transactions.

As an initial matter, proposed § 38.505 (a) revises the nomenclature for referring to transactions that have been referred to in the past as "exchange of futures for commodities or derivatives positions," to refer to all such transactions under the umbrella term "exchange of derivatives for related position" ("EDRP"). The Commission believes that this is a more accurate and descriptive term as it will include transactions not limited to futures, such as swaps. Proposed § 38.505(a) codifies the requirements and characteristics of a bona fide EDRP and is based on Commission standards that have developed over the years. Specifically, the proposed rule sets forth the elements of a bona fide EDRP to include separate but integrally related transactions, price correlation and quantitative equivalence of the two legs, an actual transfer of ownership of the commodity or derivatives position and both legs transacted between the same two parties.

As to pricing of these transactions, proposed § 38.505 maintains the methodology set forth in the acceptable practices proposed in the 2008 Core Principle 9 Proposed Rulemaking.<sup>112</sup> Accordingly, the proposed rule provides that the price differential between the two legs should reflect commercial realities, and at least one leg of the transaction should be priced at the prevailing market price.

Further, proposed § 38.505(b) codifies the requirements applicable to bona fide transitory exchange of derivatives for related position transactions. A

<sup>111</sup> See Division of Trading and Markets, Report on Exchanges of Futures for Physicals (1987) (the "1987 EFP Report"); Regulation of Non-Competitive Transactions Executed on or Subject to the Rules of a Contract Market, 63 FR 3708, Jan. 26, 1998 (the "1998 EFP Concept Release").

<sup>112</sup> The Commission is codifying the EDRP pricing methodology based on its experience over the past years in determining the reasonability of EDRP pricing.

transitory exchange of derivatives for a related position transaction involves both an EDRP and an off-setting transaction to one of the legs of that transaction. As codified in § 38.504(b), the proposed rule will permit parties to an EDRP to engage in a separate transaction that offsets a leg of the EDRP if the offsetting transaction results in an actual transfer of ownership and demonstrates other indicia of being a bona fide transaction, and the offsetting transaction is able to stand on its own as a commercially appropriate transaction; that is, there must be no obligation on either party that the offsetting transaction will require the execution of a related EDRP, or vice versa.

Proposed § 38.505(c) prohibits DCMs from permitting a contingent exchange of derivative for a related position transaction where the exchange of derivative for the related position is contingent upon an offsetting transaction.

In the 2008 Core Principle 9 Proposed Rulemaking, the Commission proposed that EDRP transactions be reported to the DCM within a reasonable time. Given the continuous changes and advancements in electronic trading over the years, the Commission believes that such trades also should be reported in a five minute time period, as is proposed for block trades. Thus, proposed § 38.505(d) requires that such trades be reported to the market within five minutes of consummation. The Commission invites comments on this proposal and, in particular, if and why any other time period should be allowed.

Proposed § 38.505(e) codifies the acceptable practice proposed in the 2008 Core Principle 9 Proposed Rulemaking requiring the DCM to follow procedures set forth in current section 16.01 to publicize daily the total quantity of exchange for derivatives for related position.

vi. Proposed § 38.506—Office Trades and Transfer Trades

In the 2008 Core Principle 9 Proposed Rulemaking, the Commission noted that transfer trades and office trades move existing positions between accounts and are bookkeeping in nature. Such transactions, therefore, do not affect the price discovery process of the centralized market because they do not establish or offset positions. The Commission will not require these transactions to follow the publication requirements under § 16.01 as required for blocks and EDRPs. Instead, proposed § 38.506 requires that records of such

<sup>110</sup> See *supra* note 43.

transactions be kept in accordance with the recordkeeping regulation § 1.31.

#### 10. Subpart K—Trade Information

Section 5(d)(10) of the CEA, as amended by the Dodd-Frank Act, requires DCMs to capture, verify, and retain detailed trade information (*i.e.*, audit trail data) for all transactions in their markets. Amended Core Principle 10—Trade Information is almost identical to the requirements contained in the current Core Principle 10. Both the amended and current Core Principle 10 require DCMs to maintain rules and procedures that provide for the recording and safe storage of all identifying trade information in a manner that enables the DCM to assist in the prevention of customer and market abuses and provide evidence of any rule violations. Because the amended core principle has almost identical statutory text, the Commission interprets amended Core Principle 10 as imposing the same substantive content as its predecessor.<sup>113</sup>

The application guidance and acceptable practices for current Core Principle 10 provide the basis of the Commission's proposed audit trail regulations in proposed subpart K, particularly proposed §§ 38.551 (Audit Trail Required) and 38.552 (Elements of an Acceptable Audit Trail Program), summarized below. In addition, the proposed rules update the guidance and acceptable practices in that the proposed regulations address audit trail requirements for electronic trading. The Commission notes that the proposed rules for electronic trading audit trails are substantially similar to the long-standing requirements for open-outcry trading. However, because those requirements reflected a time when electronic trading accounted for less than 10 percent of U.S. futures volume,

<sup>113</sup> The Commission previously expressed the regulatory requirements of former Core Principle 10 through its application guidance for that core principle. See 17 CFR part 38, App. B, Application Guidance and Acceptable Practices for Core Principle 10. It also provided additional insight regarding the core principle through detailed acceptable practices that all DCMs could use to demonstrate compliance with former Core Principle 10. The acceptable practices explained that "the goal of an audit trail is to detect and deter customer and market abuse." *Id.* at (b)(1). It also outlined the elements of an effective audit trail. Those elements included original source documents, which help to establish the accuracy and authenticity of an audit trail. They also included a transaction history database and electronic analysis capability, which allow a DCM to more easily access and review audit trail data to identify possible trading abuses and rule violations. Finally, the acceptable practices pointed to a DCM's safe storage capability, emphasizing that audit trail data must be stored in a manner that protects it from unauthorized alteration, accidental erasure, or other loss.

they did not explicitly address electronic trading.<sup>114</sup>

The proposed rules also draw on recent RERs analyzing DCMs' compliance with former Core Principle 10. In the context of RERs, staff has made a number of findings and recommendations regarding DCMs' audit trail enforcement programs, including recommendations regarding more frequent audit trail reviews and larger sanctions for audit trail violations. Staff also has directed DCMs to develop audit trail programs for electronic trading that are comparable in rigor and scope to their audit trail programs for open-outcry trading.<sup>115</sup> These findings and recommendations, including those with respect to electronic trading audit trails, are reflected in proposed § 38.553, also summarized below.

Whether applicable to open-outcry or to electronic trading, the proposed rules in subpart K seek to ensure that DCMs capture, verify, and retain sufficient order and trade-related information for DCM staff to detect possible trading violations and other market and customer abuses. They also require DCMs to possess specific resources and capabilities with respect to their audit trails. These include the ability to promptly reconstruct all transactions and the ability to track customer orders from the time of receipt through fill, allocation, or any other disposition. The proposed rules also require a DCM's audit trail program to collect original source documents, to build a transaction history database, and to develop an electronic analysis capability with respect to all trade information in that database. DCMs also must possess a safe storage capability with respect to their audit trail data. Finally, they must develop meaningful enforcement programs to ensure member and market participant compliance with all applicable audit trail requirements. In each respect, the Commission's proposed rules are consistent with its long-standing requirements and expectations regarding reliable, complete, and effective audit trails. The specific requirements of the proposed rules implementing amended Core Principle 10 are summarized below.

<sup>114</sup> This figure is based on fiscal year 2000, as reported in the Commission's FY 2009 Performance and Accountability Report, p. 14.

<sup>115</sup> See Rule Enforcement Review of the Minneapolis Grain Exchange (August 27, 2009), and Rule Enforcement Review of ICE Futures U.S. (Feb. 2, 2010).

#### i. Proposed § 38.551—Audit Trail Required

Proposed § 38.551 is based on the application guidance and acceptable practices for former Core Principle 10.<sup>116</sup> It establishes the overarching requirements for DCMs' audit trail programs to ensure that DCMs can appropriately monitor and investigate any potential customer and market abuse. Proposed § 38.551 provides that the audit trail data captured by DCMs must be sufficient to reconstruct all transactions within a reasonable period of time, and to provide evidence of any rule violations that may have occurred. The proposed rule also provides that audit trails must be sufficient to track customer orders from the time of receipt through fill, allocation, or other disposition. Audit trail data must include both order and trade information. Proposed § 38.551 applies equally to open-outcry and electronic trading.

#### ii. Proposed § 38.552—Elements of an Acceptable Audit Trail Program

Proposed § 38.552 prescribes the four elements of an acceptable audit trail program. These elements are necessary to ensure that a DCM can capture and retain sufficient trade-related information, can reconstruct trading promptly, and has the necessary tools to detect and deter potential customer and market abuses through its audit trail. First, proposed § 38.552(a) requires that a DCM's audit trail include original source documents, defined to include unalterable, sequentially-identified records on which trade execution information is originally recorded, whether manually or electronically. It also requires that customer order records demonstrate the terms of the order, the account identifier that relates to the account owner, and the time of the order entry. Finally, proposed § 38.552(a) requires that, for open-outcry trades, the time of report of order of execution must also be captured in the audit trail.

Second, proposed § 38.552(b) requires that a DCM's audit trail program must include a transaction history database. A transaction history database facilitates rapid access and analysis of all original source documents, thereby aiding DCMs in monitoring for customer and market abuses. Proposed § 38.552(b) also specifies the trade information that must be included in a transaction history database. Mandatory information includes a history of all orders and trades; all data input in the trade

<sup>116</sup> 17 CFR Part 38, App. B, Core Principle 10, Application Guidance and Acceptable Practices.



matching system for clearing; the categories of participants for which trades are executed (i.e., customer type indicator or “CTP” codes); timing and sequencing data sufficient to reconstruct trading; and identification of each account to which fills are allocated.

Third, proposed § 38.552(c) requires that a DCM’s audit trail program have electronic analysis capability for all data in its transaction history database. This requirement helps ensure effective use of audit trail data by requiring appropriate tools to use in conjunction with a DCM’s transaction history database. Proposed § 38.552(c) also provides that a DCM’s electronic analysis capability must allow it to reconstruct trades in order to identify possible rule violations.

Finally, proposed § 38.552(d) requires that a DCM’s audit trail program include the ability to safely store all audit trail data, and to retain it in accordance with the recordkeeping requirements of DCM Core Principle 18 and the associated regulations under part 38. Safe storage capability enables a DCM to properly preserve and protect the audit trail data so that it is readily available for the DCM to use in any future investigation or inquiry into possible violations of DCM rules. Safe storage capability requires a DCM to protect its audit trail data from unauthorized alteration, accidental erasure or other loss.

### iii. Proposed § 38.553—Enforcement of Audit Trail Requirements

Proposed § 38.553 prescribes the elements of an effective audit trail enforcement program. The proposed rule is organized in two parts. First, proposed § 38.553(a) requires a DCM to develop an effective audit trail enforcement program. An effective enforcement program must, at a minimum, review all members and market participants annually to verify their compliance with all applicable audit trail requirements.

Proposed § 38.553(a) is further divided into two paragraphs. Paragraph (a)(2) of proposed § 38.553 establishes minimum review criteria for open-outcry trading. It requires that DCMs conduct annual reviews of all members and market participants to verify their compliance with their trade timing, order ticket and trading card requirements. Similarly, paragraph (a)(1) sets forth minimum review criteria for an electronic trading audit trail. It requires annual examinations by DCMs of randomly selected samples of front-end audit trail data from order routing systems to ensure the presence and accuracy of required audit trail data. In addition, paragraph (a)(1) requires that

DCMs: Review the processes used by members and market participants to assign and maintain exchange user identifications; review usage patterns of the user identifications; and review account numbers and Customer Trading Identification codes in trade records to test for accuracy and improper usage. The Commission notes that, compared to the corresponding requirements for open-outcry trading, audit trail and audit trail enforcement requirements for electronic trading are still evolving, and that the Commission’s expectations in this area, pursuant to amended Core Principle 10, are likely to evolve as well.

Second, proposed § 38.553(b) requires DCMs to develop programs to ensure effective enforcement of their audit trail and recordkeeping requirements. It applies equally to both open-outcry and electronic trading. Proposed § 38.553(b) requires DCMs’ enforcement programs to identify members and market participants that routinely fail to comply with the requirements of Core Principle 10. DCMs also must levy meaningful sanctions when deficiencies are found. Sanctions may not include more than one warning letter or other non-financial penalty for the same violation within a rolling twelve-month period.

### 11. Subpart L—Financial Integrity of Transactions

Core Principle 11, as amended by the Dodd-Frank Act, retains the provisions of current Core Principle 11.<sup>117</sup> This core principle requires that a DCM establish and enforce rules and procedures for ensuring the financial integrity of transactions entered into, on or through the facilities of the contract market, including the clearing and settlement of the transactions with a DCO. Amended Core Principle 11 also requires that a DCM establish and enforce rules to ensure: (i) The financial integrity of any futures commission merchant (“FCM”) and introducing broker (“IB”); and (ii) the protection of customer funds. Because textually the language is almost the same, the Commission is interpreting the provisions as it has in the past. Proposed §§ 38.600 through 38.607, largely codify language found in the

existing application guidance for current Core Principle 11 and former Designation Criterion 5.<sup>118</sup> However, based upon its past experience, the Commission is proposing some new practices and requirements for DCMs in implementing amended Core Principle 11.

Proposed § 38.601 would require that all transactions executed on or through a DCM, other than transactions in security futures products, be cleared through a Commission-registered DCO. This proposed rule codifies current practice, as well as the requirements of amended Core Principle 11 to mandate clearing. The Commission interprets the mandatory clearing requirement in Section 723(a)(3) of the Dodd-Frank Act<sup>119</sup> to mean that a DCO must clear a swap for any DCM or SEF that requests such clearing services, so long as the DCO offers the swap for clearing. In addition, a DCO that is clearing particular swaps must also clear the same swaps when listed on DCMs or SEFs, whether affiliated or unaffiliated, on a nondiscriminatory basis.

Proposed §§ 38.602 and 38.603 provide that DCMs must adopt rules establishing minimum financial standards for both member FCMs and IBs and non-intermediated market participants, as well as rules for the protection of customer funds, including the segregation of customer and proprietary funds, the custody of customer funds, the investment standards for customer funds, intermediary default procedures and related recordkeeping. Proposed § 38.604 requires that a DCM must routinely receive and promptly review financial and related information from its members and conduct ongoing financial surveillance of the risk created by the positions the customers of an FCM take on the DCM. To meet this requirement, the DCM must have rules pertaining to minimum financial standards of intermediaries that include, among other things, rules prescribing minimum capital requirements for

<sup>118</sup> Former Designation Criterion 5 stated that “the board of trade shall establish and enforce rules and procedures for ensuring the financial integrity of transactions entered into by or through the facilities of the contract market, including the clearance and settlement of the transactions with a derivatives clearing organization.” 17 CFR part 38, App. A.

<sup>119</sup> Among other things, section 723(a)(3) of the Dodd-Frank Act adds a new section 2(h)(1) to the CEA that provides that: (i) All swaps that are required to be cleared by a Commission-registered DCO; and (ii) a DCO must have open access rules, including rules providing for the non-discriminatory clearing of a swap executed bilaterally on or through the rules of an unaffiliated DCM or SEF.

<sup>117</sup> There were no substantive changes to the amended Core Principle 11 from the current one. The amended core principle reads as follows: The board of trade shall establish and enforce—(A) rules and procedures for ensuring the financial integrity of transactions entered into on or through the facilities of the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization); and (B) rules to ensure: (i) The financial integrity of any (I) futures commission merchant, and (II) introducing broker; and (ii) the protection of customer funds.

member FCMs and IBs.<sup>120</sup> Rules or procedures pertaining to protection of customer funds must include, among other things, that each DCM must continually survey the obligations of each FCM created by the positions of its customers, and, as appropriate, compare those obligations to the financial resources of the FCM. The DCM should use this information to protect customer funds by, for example, taking appropriate steps to verify that its member FCMs have sufficient capital to continue to guarantee the positions of each customer. If the obligations of a member FCM appear excessive as compared to the capital of such FCM, a DCM should take appropriate action, including contacting the FCM or the FCM's designated self-regulatory organization.

Proposed § 38.605 requires DCMs as self-regulatory organizations ("SRO") to comply with the standards of amended § 1.52 to ensure the financial integrity of intermediaries by establishing and carrying out an SRO program for the examination and financial supervision of intermediaries. Section 1.52, as proposed to be amended in this release, sets forth the required elements of SRO supervisory programs and permits one or more SROs to establish, subject to Commission approval, a joint audit plan to provide for the SRO supervision of members of more than one SRO. Proposed amendments to § 1.52 include references to existing guidance to SROs contained in the Division of Trading and Markets Financial and Segregation Interpretations 4-1 and 4-2, which currently guide the practices of members of the Joint Audit Committee operating a joint audit plan that has been approved by the Commission.<sup>121</sup>

Proposed § 38.606 would provide that DCMs may satisfy their financial surveillance responsibilities under proposed §§ 38.604 and 38.605 by outsourcing such responsibilities to a registered futures association or other regulated entity. Proposed § 38.606 would provide that a DCM must ensure that the regulatory service provider has the capacity and resources to conduct the necessary financial surveillance, and would further provide that the DCM remains responsible for compliance with its financial surveillance obligations notwithstanding the use of a regulatory service provider.

<sup>120</sup> An FCM that is a clearing member will also have additional obligations to the DCO as a result of its clearing membership.

<sup>121</sup> See 73 FR 52832, Sept. 11, 2008 (requesting comments prior to the Commission's approval of the most recent Joint Audit Committee agreement, which approval was granted March 18, 2009).

As noted above, amended Core Principle 11 provides that a DCM must establish and enforce rules to, among other things, ensure both the financial integrity of any FCM, and the protection of customer funds. With an increasing number of DCMs permitting the customers of an FCM to transmit orders directly to the DCM in real time, the ability of an FCM to control and monitor its level of risk may become compromised. In this automated trading environment, the only controls that effectively can enforce limitations on risk are automated controls.<sup>122</sup> Proposed § 38.607 would require a DCM that allows customers direct access to its contract market to implement certain direct access controls and procedures in order to provide member FCMs with tools to manage their financial risk. The proposed rule contemplates that an FCM would continue to have primary responsibility for overall risk management, but that the DCM would be required to establish an automated risk management system permitting an FCM to set appropriate risk limits for each customer with direct access to the contract market. As an SRO, the DCM would be responsible for implementing and enforcing rules requiring the FCM to use the provided controls and procedures appropriately. The specific type of pre-trade controls implemented by a DCM shall be a matter for determination by the DCM, its member FCMs, and the DCM's DCO. This proposed rule requiring direct access controls and procedures where direct access is permitted is consistent with current international guidance.<sup>123</sup> The Commission requests comments on the proposed rule, and specifically on the following questions:

- Whether DCMs should provide additional controls to permit FCMs to manage their risks? If so, what specific direct access controls and procedures should DCMs implement?
- Should such controls be mandatory?

## 12. Subpart M—Protection of Markets and Market Participants

Section 735 of the Dodd-Frank Act amends Core Principle 12. Current Core Principle 12 states that the board of trade shall establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants. The amended Core Principle 12 requires that

the DCM establish and enforce rules to protect markets and market participants from abusive practices committed by any party, including abusive practices committed by a party acting as an agent for a participant, and promote fair and equitable trading on the contract market. The current guidance for this core principle<sup>124</sup> provides that a DCM should have methods and resources appropriate to the nature of the trading system and the structure of the market to detect trade practice and market abuses, and to prohibit, detect and discipline intermediary behavior that is abusive, fraudulent, noncompetitive or unfair, in connection with the execution of trades.

The Commission believes that compliance with this core principle requires the DCM to implement trade practice and market surveillance programs and provide a competitive, open and efficient market and mechanism for executing transactions in accordance with other core principles and the regulations thereunder. To provide clarity and certainty of these requirements, the Commission proposes § 38.651 that specifically states compliance requirements, including the core principles that must be followed. Specifically, a trade practice surveillance program should be conducted in accordance with Core Principle 2 and the associated regulations in subpart C of this part 38, which would require, among other things, that a DCM prohibit certain enumerated abusive and disruptive trading practices, have arrangements and resources for effective rule enforcement and enforce compliance with its rules and have the capacity to detect, investigate, and sanction violations.

A market surveillance program should include monitoring the market to prevent manipulation, price distortion and disruptions of daily trading and the physical delivery or cash-settlement process. A market surveillance program should be conducted in accordance with Core Principle 4 and the associated regulations in subpart E of this part 38 that would require, among other things, that the DCM demonstrate the capability of conducting real-time monitoring of trading and comprehensive and accurate

<sup>124</sup> The current guidance for Core Principle 12 provides that "a designated contract market should have rules prohibiting conduct by intermediaries that is fraudulent, noncompetitive, unfair, or an abusive practice in connection with the execution of trades and a program to detect and discipline such behavior. The contract market should have methods and resources appropriate to the nature of the trading system and the structure of the market to detect trade practice abuses." 17 CFR part 38, App. B.

<sup>122</sup> International Organization of Security Commissions [IOSCO], Final Report of the IOSCO Technical Committee, Principles for Direct Electronic Access to Markets, at 4, IOSCO Doc. FR08/10 (August 12, 2010).

<sup>123</sup> *Id.*

trade reconstructions and require that traders in their markets keep records, including their activity in the underlying commodity and related derivative markets. Effectively monitoring the market would require sufficient, well trained market surveillance staff and, where appropriate, automated tools to assist in the monitoring of the market for, among other things, potential market disruptions. Such automated tools should be capable of providing automated trading alerts to detect many types of potential violations of exchange or Commission rules.

Finally, in order to promote fair and equitable trading, the DCM must establish and enforce trading rules with adequate specificity to include, among other things, providing to market participants, on a fair, equitable and timely basis, information regarding prices, bids and offers. The DCM should provide a competitive, open and efficient market and mechanism for executing transactions in accordance with Core Principle 9 and the associated regulations in subpart J of this part 38 that, among other things, recognizes that trading in the centralized market provides a price discovery function and would specifically require that the execution of transactions be in a manner that protects that price discovery process.

### 13. Subpart N—Disciplinary Procedures

Section 735 of the Dodd-Frank Act amends the disciplinary procedure requirements applicable to DCMs in two significant ways. First, Section 735(a) eliminates all DCM designation criteria, including Designation Criterion 6 (Disciplinary Procedures).<sup>125</sup> Second, Section 735(b) creates a new Core Principle 13 (Disciplinary Procedures) that is devoted exclusively to exchange disciplinary proceedings, and that captures disciplinary concepts inherent in both Designation Criterion 6 and in current DCM Core Principle 2 (Compliance with Rules).<sup>126</sup> The rules proposed under subpart N implement new Core Principle 13.<sup>127</sup>

<sup>125</sup> See § 735(a) of the Dodd-Frank Act.

<sup>126</sup> Compare current CEA § 5(b)(6) and § 5(d)(2) with CEA § 5(d)(13) as amended by the Dodd-Frank Act.

<sup>127</sup> Prior to the passage of the Dodd-Frank Act, the standards for DCMs' disciplinary practices were found in Designation Criterion 6 and the statutory language, guidance, and acceptable practices for former Core Principle 2. Designation Criterion 6 required that a DCM establish and enforce disciplinary procedures that authorized it to discipline, suspend, or expel members or market participants that violated the rules of the DCM, or similar methods for performing the same functions, including delegation of the functions to third

The proposed rules in subpart N are consistent with current disciplinary practices at most DCMs. They reflect disciplinary concepts formerly found in Designation Criterion 6 and the guidance and acceptable practices for former Core Principle 2. The proposed rules also are similar to the text of the disciplinary procedures in part 8 of the Commission's regulations.<sup>128</sup> In general, the Commission's proposed rules seek to ensure a fair, prompt, and effective disciplinary program. They require meaningful sanctions against persons and entities that violate DCM rules. The proposed rules also provide numerous procedural safeguards to ensure fairness for all respondents in disciplinary actions. Finally, they require full customer restitution in any disciplinary matter where customer harm is demonstrated.

In those cases where the proposed rules place new requirements on DCMs with respect to their disciplinary procedures, such requirements are derived from findings and recommendations made by Commission staff through its RERs. Proposed § 38.701 (Enforcement Staff), for example, requires a DCM to have sufficient staff and resources to effectively and promptly prosecute possible violations of exchange rules. It also requires a DCM to monitor the size and workload of its enforcement staff annually, and to increase its enforcement resources and staff as appropriate. The text of proposed rule 38.701 mirrors that of proposed rule 38.155, which requires DCMs to retain sufficient compliance staff and resources to comply with new DCM

parties. Paragraph (a)(2) of the application guidance for former Core Principle 2 required DCMs to have the "arrangements, resources, and authority [necessary] for effective rule enforcement," and the "authority and ability to discipline and limit, or suspend the activities of a member or market participant pursuant to clear and fair standards." 17 CFR part 38, App. B, Application Guidance for Core Principle 2 at (a)(2). In addition, paragraph (b)(4) of the former core principle's acceptable practices required any DCM that wished to take advantage of the acceptable practice's safe harbor to have "prompt and effective disciplinary action for any violation \* \* \* found to have been committed." 17 CFR part 38, App. B, Acceptable Practices for Core Principle 2 at (b)(4). Paragraph (b)(4) also referenced part 8 of the Commission's regulations as an example that DCMs could follow to comply with Core Principle 2. 17 CFR 8.01 *et seq.* In its experience, the Commission has found that many DCMs' disciplinary programs do in fact model the disciplinary structures and processes in part 8. While the acceptable practices for former Core Principle 2 offered the disciplinary procedures in part 8 as an example of appropriate disciplinary procedures, DCMs were exempt from part 8 pursuant to § 38.2. The disciplinary procedures proposed herein do not re-subject DCMs to part 8, but rather propose new disciplinary procedures for inclusion in part 38.

<sup>128</sup> See *supra* note 47.

Core Principle 2—Compliance with Rules.<sup>129</sup>

Other proposed requirements in subpart N that are based on findings and recommendations in recent RERs include a requirement that disciplinary panels improve their written documentation in disciplinary decisions and settlements.<sup>130</sup> These heightened documentation requirements appear in proposed § 38.703 (Review of Investigation Report), proposed § 38.709 (Settlement Offers), and proposed § 38.711 (Decisions), all of which require that the facts and analysis supporting disciplinary settlements and decisions be explained carefully and in writing by the relevant disciplinary panel. The Commission believes that improved written documentation, as required by the proposed rules, will yield a number of significant benefits. Disciplinary panels will be required to focus their analysis more carefully in order to articulate the rationale for their decisions. DCM enforcement staff will gain a better understanding of the evidentiary expectations to which different disciplinary panels adhere. DCM enforcement staff and respondents will both have an improved record to base any appeals they may wish to file. Finally, improved written documentation of the facts and analysis supporting settlements and disciplinary decisions will help facilitate subsequent review of DCMs' disciplinary programs by the Commission.

Proposed § 38.714 (Disciplinary Sanctions), further provides that all disciplinary penalties imposed by a DCM or its disciplinary panels must be commensurate with the violations committed, and be sufficient to deter recidivist activity. This proposed rule reflects DMO staff's concerns with respect to the adequacy of disciplinary sanctions in cases it has examined through its RER process.<sup>131</sup> Finally, proposed § 38.715 (Summary Fines for Violations of Rules Regarding Timely

<sup>129</sup> See Rule Enforcement Review of the Minneapolis Grain Exchange (Aug. 27, 2009), Rule Enforcement Review of ICE Futures U.S. (Feb. 2, 2010), and Rule Enforcement Review of the Chicago Board of Trade and the Chicago Mercantile Exchange (Sep. 13, 2010) for findings and recommendations pertaining to the adequate staff size of DCM compliance departments.

<sup>130</sup> See Rule Enforcement Review of the New York Mercantile Exchange (Sep. 16, 2004) and Rule Enforcement Review of the Chicago Board of Trade and the Chicago Mercantile Exchange (Sep. 13, 2010). The structure of disciplinary panels is discussed in the context of proposed § 38.702, below.

<sup>131</sup> See Rule Enforcement Review of the New York Mercantile Exchange (Sep. 16, 2004); Rule Enforcement Review of the Kansas City Board of Trade (June 16, 2006); and Rule Enforcement Review of the Minneapolis Grain Exchange (Aug. 27, 2009).

Submission of Records, Decorum, or Other Similar Activities) makes clear that a DCM should issue no more than one warning letter in a rolling 12-month period before sanctions are imposed, again reflecting DMO staff's concerns with respect to the adequacy of sanctions imposed. Proposed subpart N is divided into a total of 16 rules, each of which is described in detail below.

i. Proposed § 38.701—Enforcement Staff

Proposed § 38.701 requires that a DCM establish and maintain sufficient enforcement staff and resources to effectively and promptly prosecute possible rule violations within the jurisdiction of the contract market. A DCM must also monitor the size and workload of its enforcement staff annually and increase its resources and staff as appropriate. The Commission recognizes that at some DCMs, compliance staff also serves as enforcement staff. That is, they both investigate cases and present them before disciplinary panels. These proposed rules are not intended to prohibit that practice.

The Commission believes that adequate staff and resources are essential to the effective performance of a DCM's disciplinary program. As noted previously, this is reflected in DMO staff's findings and recommendations in recent RERs, in which DMO staff recommended that DCMs increase their compliance staff levels and monitor the size of their staff and increase the number of staff appropriately as trading volume increases, new responsibilities are assigned to compliance staff, or internal reviews demonstrate that work is not completed in an effective or timely manner.

Proposed § 38.701 also provides that a DCM's enforcement staff may not include members of the exchange or persons whose interests conflict with their enforcement duties. Moreover, a member of the enforcement staff may not operate under the direction or control of any person or persons with trading privileges at the contract market. These provisions seek to ensure the independence of enforcement staff, and help promote disciplinary procedures that are free of potential conflicts of interest.

ii. Proposed § 38.702—Disciplinary Panels

Proposed § 38.702 requires a DCM to establish one or more Review Panels and one or more Hearing Panels (together, "disciplinary panels") to fulfill its obligations under this section. The composition of both panels must meet the composition requirements of

proposed § 40.9(c)(3)(ii)<sup>132</sup> and may not include any members of the DCM's compliance staff, or any person involved in adjudicating any other stage of the same proceeding. Paragraph (b) of the proposed rule provides that a Review Panel must be responsible for determining whether a reasonable basis exists for finding a violation of contract market rules, and for authorizing the issuance of a notice of charges against persons alleged to have violated exchange rules. If a notice of charges is issued, then Paragraph (c) of the proposed rule helps to ensure an impartial hearing by requiring a separate Hearing Panel to adjudicate the matter and issue sanctions. The Commission notes that, while proposed § 38.702 requires DCMs to empanel distinct bodies to issue charges and to adjudicate charges in a particular matter, DCMs may determine for themselves whether their Review and Hearing Panels are separate standing panels or ad hoc bodies whose members are chosen from a larger "disciplinary committee" to serve in one capacity or the other for a particular disciplinary matter.

iii. Proposed § 38.703—Review of Investigation Report

Proposed § 38.703 requires a Review Panel to promptly review an investigation report received pursuant to proposed § 38.158(c). In addition, a Review Panel must take action on any investigation report received within 30 days of such receipt. The Commission believes that prompt action by all disciplinary panels is necessary for an effective disciplinary program. Among other considerations, prompt disciplinary action provides the best opportunity for witnesses to recall conversations, facts, and other information relevant to the matter. In addition, prompt and effective disciplinary action provides a clear signal to the market and to market

<sup>132</sup> Section 40.9(c)(3)(ii), as proposed in the separate release titled Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, provides that "Each Disciplinary Panel shall include at least one person who would not be disqualified from serving as a Public Director by § 1.3(ccc)(1)(i)-(vi) and (2) of this chapter (a "Public Participant"). Such Public Participant shall chair each Disciplinary Panel. In addition, any registered entity specified in paragraph (c)(3)(i) of this section shall adopt rules that would, at a minimum: (A) Further preclude any group or class of participants from dominating or exercising disproportionate influence on a Disciplinary Panel and (B) Prohibit any member of a Disciplinary Panel from participating in deliberations or voting on any matter in which the member has a financial interest." See 75 FR 63732, Oct. 18, 2010.

participants that violations of exchange rules will not be tolerated by the DCM.

After receipt of the investigation report, if a Review Panel determines that additional investigation or evidence is needed, it must promptly direct the compliance staff to conduct further investigation. In the alternative, if a Review Panel determines that no reasonable basis exists for finding a violation, or that prosecution is unwarranted, it may direct that no further action be taken. This determination must include a written statement setting forth the facts and analysis supporting the decision. Finally, if a Review Panel determines that a reasonable basis exists for finding a violation and adjudication is warranted, it must direct that the person or entity alleged to have committed the violation be served with a notice of charges.

iv. Proposed § 38.704—Notice of Charges

Proposed § 38.704 describes the minimally acceptable contents of a notice of charges ("notice") issued by a Review Panel. The notice must adequately state the acts, conduct, or practices in which the respondent is alleged to have engaged; state the rule, or rules, alleged to have been violated; and prescribe the period within which a hearing on the charges may be requested. Further, the notice must also advise the respondent charged that he is entitled, upon request, to a hearing on the charges. Pursuant to paragraphs (a) and (b) of the proposed rule, the DCM may adopt rules providing that (1) the failure to request a hearing within the time prescribed in the notice, except for good cause, may be deemed a waiver of the right to a hearing; and (2) the failure to answer or deny expressly a charge may be deemed to be an admission of such charge.

v. Proposed § 38.705—Right to Representation

Proposed § 38.705 requires that, upon being served with a notice of charges, a respondent must have the right to be represented by counsel or any other representative of his choosing in all succeeding stages of the disciplinary process. Together with proposed §§ 38.704 (requiring an adequate notice of charges to the respondent), 38.708 (conferring the right to hearing), and 38.710 (hearing procedures), 38.705 is one of the primary proposed rules in subpart N that helps ensure basic fairness for respondents in disciplinary proceedings.

vi. Proposed § 38.706—Answer to Charges

Proposed § 38.706 provides that a respondent must be given a reasonable period of time to file an answer to a charge. In general, paragraphs (a) through (c) of the proposed rule provide that the rules of the DCM may require that: (1) The answer must be in writing and include a statement that the respondent admits, denies or does not have and is unable to obtain sufficient information to admit or deny each allegation; (2) failure to file an answer on a timely basis shall be deemed an admission of all allegations in the notice of charges; and (3) failure in an answer to deny expressly a charge shall be deemed to be an admission of such charge.

vii. Proposed § 38.707—Admission or Failure to Deny Charges

Proposed § 38.707 provides that, if a respondent admits or fails to deny any of the violations alleged in a notice of charges, then a Hearing Panel may find that the violations admitted or not denied have in fact been committed. If a DCM adopts a rule concerning the admission or failure to deny charges, then Sections (a) through (c) of the proposed rule provide that: (1) The Hearing Panel must impose a sanction for each violation found to have been committed; (2) the DCM must promptly notify the respondent in writing of any sanction to be imposed and advise the respondent that they may request a hearing on such sanction within the period of time stated in the notice; and (3) the rules of the DCM may provide that if the respondent fails to request a hearing within the period of time stated in the notice, then the respondent will be deemed to have accepted the sanction.

viii. Proposed § 38.708—Denial of Charges and Right to Hearing

Proposed § 38.708 provides that in every instance where a respondent has requested a hearing on a charge that he or she denies, or on a sanction set by the Hearing Panel pursuant to proposed § 38.707, the respondent must be given the opportunity for a hearing in accordance with the requirements of proposed § 38.710. The DCM's rules may provide that, except for good cause, the hearing must be concerned only with those charges denied or sanctions set by the Hearing Panel under proposed § 38.707 for which a hearing has been requested.

ix. Proposed § 38.709—Settlement Offers

Proposed § 38.709 provides the procedures a DCM must follow if it permits the use of settlements to resolve disciplinary cases. Section (a) of the proposed rule states that the rules of a DCM may permit a respondent to submit a written offer of settlement any time after an investigation report is completed. The disciplinary panel presiding over the matter may accept the offer of settlement, but may not alter the terms of the offer unless the respondent agrees. In addition, Section (b) of the proposed rule provides that the rules of the DCM may allow a disciplinary panel to permit the respondent to accept a sanction without admitting or denying the rule violations upon which the sanction is based.

Section (c) of proposed § 38.709 states that a disciplinary panel accepting a settlement offer must issue a written decision specifying the rule violations it has reason to believe were committed, and any sanction imposed, including any order of restitution where customer harm has been demonstrated. Importantly, Section (c) also provides that if an offer of settlement is accepted without the agreement of a DCM's enforcement staff, the decision must carefully explain the disciplinary panel's acceptance of the settlement. Finally, Section (d) of proposed § 38.709 allows a respondent to withdraw his or her offer of settlement at any time before final acceptance by a disciplinary panel. If an offer is withdrawn after submission, or is rejected by a disciplinary panel, the respondent must not be deemed to have made any admissions by reason of the offer of settlement and must not be otherwise prejudiced by having submitted the offer of settlement.

x. Proposed § 38.710—Hearings

Proposed § 38.710 requires a DCM to adopt rules that provide certain minimum requirements for any hearing conducted pursuant to a notice of charges. In general, Sections (a)(1) through (a)(7) of the proposed rule require the following requirements: (1) A fair hearing; (2) authority for a respondent to examine evidence relied on by enforcement staff in presenting the charges contained in the notice of charges; (3) the DCM's enforcement and compliance staffs must be parties to the hearing and the enforcement staff must present its case on those charges and sanctions that are the subject of the hearing; (4) the respondent must be entitled to appear personally at the hearing, have the authority to cross-

examine persons appearing as witnesses at the hearing, and call witnesses and present evidence as may be relevant to the charges; (5) the DCM must require persons within its jurisdiction who are called as witnesses to participate in the hearing and produce evidence; (6) a copy of the hearing must be made and become a record of the proceeding if the respondent has requested a hearing; and (7) the rules of the DCM may provide that the cost of transcribing the record must be borne by a respondent who requests a transcript. Additionally, proposed paragraph (b) specifies that the rules of the DCM may provide that a sanction be summarily imposed upon any person within its jurisdiction whose actions impede the progress of a hearing.

xi. Proposed § 38.711—Decisions

Proposed § 38.711 details the procedures that a Hearing Panel must follow in rendering disciplinary decisions. The proposed rule requires that all decisions include: (1) A notice of charges or a summary of the charges; (2) the answer, if any, or a summary of the answer; (3) a summary of the evidence produced at the hearing or, where appropriate incorporation by reference in the investigation report; (4) a statement of findings and conclusions with respect to each charge, and a careful explanation of the evidentiary and other basis for such findings and conclusions with respect to each charge; (5) an indication of each specific rule with which the respondent was found to have violated; and (6) a declaration of any penalty imposed against the respondent, including the basis for such sanctions and the effective date of such sanctions.

xii. Proposed § 38.712—Right to Appeal

Proposed § 38.712 provides the procedures that a DCM must follow in the event that the DCM's rules authorize an appeal of adverse decisions in all or in certain classes of cases. Notably, the proposed rule requires a DCM that permits appeals by disciplinary respondents to also permit appeals by its enforcement staff. This provision reflects the Commission's belief that DCM enforcement staff must have the discretion to appeal disciplinary panel decisions that, for example, do not adequately sanction a respondent's violative conduct.

For DCMs that permit appeals, the language in paragraphs (a) through (d) of proposed § 38.712 generally requires the DCM to: (1) Establish an appellate panel that is authorized to hear appeals; (2) ensure that the appellate panel composition is consistent with

§ 40.9(c)(iv) of the Commission's regulations and does not include any members of the DCM's compliance staff, or any person involved in adjudicating any other stage of the same proceeding; (3) except for good cause shown, conduct the appeal or review solely on the record before the Hearing Panel, the written exceptions filed by the parties, and the oral or written arguments of the parties; and (4) issue a written decision of the board of appeals and provide a copy to the respondent promptly following the appeal or review proceeding.

#### xiii. Proposed § 38.713—Final Decisions

Proposed § 38.713 requires that each DCM establish rules setting forth when a decision rendered under this subpart N will become the final decision of the DCM.

#### xiv. Proposed § 38.714—Disciplinary Sanctions

Proposed § 38.714 requires that every disciplinary sanction imposed by a DCM must be commensurate with the violations committed and must be clearly sufficient to deter recidivism or similar violations by other market participants. Additionally, the proposed rule requires that, in the event of demonstrated customer harm, any disciplinary sanction must include full customer restitution. In evaluating appropriate sanctions, the proposed rule requires the DCM to take into account a respondent's disciplinary history.<sup>133</sup>

#### xv. Proposed § 38.715—Summary Fines for Violations of Rules Regarding Timely Submission of Records, Decorum, or Other Similar Activities

Proposed § 38.715 permits a DCM to adopt a summary fine schedule for violations of rules relating to timely submission of accurate records required for clearing or verifying each day's transactions, decorum, attire, or other similar activities. A DCM may authorize its compliance staff to summarily impose minor sanctions against persons within the DCM's jurisdiction for violating such rules. The proposed rule makes clear that a DCM should issue no more than one warning letter in a rolling 12-month period for the same violation before sanctions are imposed. Additionally, the proposed rule specifies that a summary fine schedule must provide for progressively larger fines for recurring violations.

<sup>133</sup> Proposed § 38.158(c), which is being proposed as part of this release with respect to Core Principle 2, requires that a copy of a member or market participant's disciplinary history be included in the compliance staff's investigation report.

#### xvi. Proposed § 38.716—Emergency Disciplinary Actions

Proposed § 38.716 provides that a DCM may impose a sanction, including a suspension, or take other summary action against a person or entity subject to its jurisdiction upon a reasonable belief that such immediate action is necessary to protect the best interest of the marketplace. The proposed rule also provides that any emergency action taken by the DCM must be in accordance with certain procedural safeguards that protect the respondent, including the right to be served with notice before the action is taken or otherwise at the earliest possible opportunity after action has been taken; the right to be represented by legal counsel in any proceeding subsequent to the emergency disciplinary action; the right to a hearing as soon as reasonably practical; and the right to receive a written decision on the summary action taken by the DCM.

#### 14. Subpart O—Dispute Resolution

Under the Dodd-Frank Act current Core Principle 13 is not substantively changed but it is renumbered as Core Principle 14. This core principle governs the obligations of DCMs to implement and enforce a dispute resolution program for their market participants and market intermediaries.<sup>134</sup> Currently, compliance with the core principle is guided by application guidance and acceptable practices in Appendix B of part 38. Based upon the Commission's experience over the last 10 years, this guidance has been successful in enabling DCMs to structure the appropriate dispute resolution program for themselves. Accordingly, the Commission proposes to maintain the guidance and acceptable practices, adding only clarifying changes that do not revise the substantive obligations of DCMs with respect to this core principle.

#### 15. Subpart P—Governance Fitness Standards

The Dodd-Frank Act redesignated former current Core Principle 14 as Core Principle 15. The language of this core principle remains unchanged and requires the DCM to establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other persons with direct access to the facility (including any parties affiliated with any of the persons described in this core principle). This release proposes to

<sup>134</sup> 17 CFR part 38, App. B.

codify the statutory text of the core principle in proposed § 38.800. The applicable regulations implementing this core principle will be proposed in a forthcoming rulemaking, expected to be completed by the statutory deadline of July 15, 2011.<sup>135</sup>

#### 16. Subpart Q—Conflicts of Interest

The Dodd-Frank Act redesignated current Core Principle 15 (Conflicts of Interest) as Core Principle 16. However, in all other respects, Dodd-Frank did not substantively amend the core principle. This release proposes to codify the statutory text of the core principle in proposed § 38.850. The applicable regulations implementing this core principle were proposed in a separate release titled "Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest."<sup>136</sup>

#### 17. Subpart R—Composition of Governing Boards of Contract Markets

The Dodd-Frank Act redesignated the former Core Principle 16 (Composition of Governing Boards of Mutually Owned Contract Markets) as Core Principle 17. In addition, current Core Principle 16 was amended by: (i) Changing the title of the core principle to "Composition of Governing Boards of Contract Markets"; and (ii) revising the scope of the core principle such that it now requires the governance arrangements of all DCMs to be designed to permit the consideration of the views of market participants.<sup>137</sup> This release proposes to codify the statutory text of the core principle in proposed § 38.900. The applicable regulations implementing this core principle will be proposed in a forthcoming rulemaking, which is expected to be completed by the statutory deadline of July 15, 2011.<sup>138</sup>

#### 18. Subpart S—Recordkeeping

The Dodd-Frank Act designated current Core Principle 17 (Recordkeeping) as Core Principle 18. In almost all respects, Dodd-Frank did not substantively amend the Core Principle. Under current Core Principle 17, DCMs

<sup>135</sup> See CFTC Web site for additional information on the "Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities, Additional Requirements Regarding the Mitigation of Conflicts of Interest," at [http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF\\_9\\_DCOGovernance/index.htm](http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_9_DCOGovernance/index.htm) (last visited Dec. 14, 2010).

<sup>136</sup> 75 FR 63732, Oct. 18, 2010.

<sup>137</sup> Former Core Principle 16, which applied only to mutually owned DCMs, required such DCMs to ensure that the composition of their governing boards included market participants.

<sup>138</sup> See supra note 131.

are required to maintain records of all activities related to their business as DCMs, in a form and manner acceptable to the Commission, “for a period of 5 years.”<sup>139</sup> The Commission adopted acceptable practices for this core principle by stating that DCMs could comply with the core principle by complying with § 1.31 of the Commission’s regulations (“§ 1.31”). Section 1.31 establishes recordkeeping requirements for all books and records required to be kept under the CEA, whether by a DCM or otherwise and requires that books and records be kept “for a period of 5 years.”<sup>140</sup> The Commission proposes to maintain compliance with § 1.31 as a primary component of compliance with this core principle, and proposes to incorporate the requirements in § 1.31 into proposed § 38.951.

One notable change in the amended core principle is that while current Core Principle 17 requires that records be retained for 5 years, the amended Core Principle (18) now requires that records be retained for “at least 5 years.”<sup>141</sup> Accordingly, proposed § 38.951 permits the Commission to extend DCMs’ recordkeeping requirements beyond the five years otherwise required of all entities by § 1.31, should it elect to do so. Thus, by its terms, the proposed rule requires DCMs to “maintain records of all activities relating to the business of the contract market, in a form and manner acceptable to the Commission, for a period of at least 5 years.” In addition, DCMs must “maintain such records, including trade records and investigatory and disciplinary files, in accordance with the requirements of § 1.31 [of the Commission’s regulations].”

By incorporating § 1.31, and more specifically, by incorporating § 1.31(a), proposed § 38.951 effectively requires that DCMs’ books and records be readily accessible for the first two years of the minimum five-year statutory period and be open to inspection by any representatives of the Commission or the United States Department of Justice. The DCM, at its own expense, must promptly provide either a copy or the original book or record upon request.

Proposed § 38.951 also effectively incorporates current § 1.31(b)’s description of the permissible methods of storing books and records. Consequently, a DCM may store its books and records on either

micrographic media, such as microfilm or microfiche or any similar medium, or electronic storage media as defined by § 1.31(b)(1)(ii).<sup>142</sup> DCMs must, at all times, have the facilities to immediately produce the micrographic media or electronic storage media images and be prepared to present legible hard-copy images of such records. Additionally, DCM’s must keep only Commission-required records on the media, store a duplicate of the record at a separate location, and organize and maintain an accurate index of all information maintained on both the original and duplicate storage media. DCMs that use electronic storage media are also required to develop and maintain an audit system to track the initial entry of original or duplicate records and any subsequent changes made thereafter.

Finally, proposed § 38.951 also incorporates §§ 1.31(c) and 1.31(d). Section 1.31(c) of the Commission’s regulations requires record-keepers who employ an electronic storage system to certify with the Commission that the system meets the requirements of an electronic storage media as defined in § 1.31(b)(1)(ii). Section 1.31(d) states that trading cards, documents on which trade information is originally recorded in writing, certain written orders, and paper copies of certain electronically filed forms and reports with original signatures must be retained in hard-copy for the requisite time period. The proposed rule also requires a DCM to comply with the requirements of proposed § 45.1—“Swap Recordkeeping Requirements”—if applicable to the DCM.

#### 19. Subpart T—Antitrust Considerations

Current Core Principle 18 governs the antitrust obligations of DCMs.<sup>143</sup> The Dodd-Frank Act renumbered this core principle as Core Principle 19, but in all other respects the statutory text of the core principle is the same. The Commission believes that the existing guidance to this Core Principle remains appropriate. Accordingly, other than to codify the statutory text of Core Principle 19 into the proposed § 38.1000, the Commission at this time is not proposing any amendments to the relevant guidance under part 38.

Proposed § 38.1001 refers applicants and DCMs to the guidance in Appendix

<sup>142</sup> Among other criteria, § 1.31(b)(1)(ii) defines electronic storage media as “any digital storage medium or system that preserves the records exclusively in a non-rewritable, non-erasable format [and] verifies automatically the quality and accuracy of the storage media recording process \* \* \*.”

<sup>143</sup> Part 38 contains guidance governing compliance with Core Principle 18. 17 CFR part 38, App. B.

B to part 38 for purposes of demonstrating to the Commission their compliance with the requirements of proposed § 38.1000.20.

#### 20. Subpart U—System Safeguards

Proposed § 38.1051 establishes system safeguards requirements for all DCMs, pursuant to new Core Principle 20 added under the Dodd-Frank Act. Core Principle 20, codified in § 38.1050 requires DCMs to: (1) Establish and maintain a program of risk oversight to identify and minimize sources of operational risk through the development of appropriate controls and procedures and the development of automated systems that are reliable, secure, and have adequate scalable capacity; (2) establish and maintain emergency procedures, backup facilities, and a plan for disaster recovery that allow for the timely recovery and resumption of operations and the fulfillment of the responsibilities and obligations of the DCM; and (3) periodically conduct tests to verify that backup resources are sufficient to ensure continued order processing and trade matching, price reporting, market surveillance, and maintenance of a comprehensive and accurate audit trail. The rules proposed under subpart U implement these requirements.

Because automated systems play a central and critical role in today’s electronic financial market environment, oversight of core principle compliance by DCMs with respect to automated systems is an essential part of effective oversight of both futures and swaps markets. Sophisticated computer systems are crucial to a DCM’s ability to meet its obligations and responsibilities. Safeguarding the reliability, security, and capacity of such systems is also essential to mitigation of systemic risk for the nation’s financial sector as a whole. This is particularly true in light of the fact that the over-the-counter swaps market is estimated to have in excess of \$600 trillion in outstanding contracts, roughly 40 times the gross domestic product of the United States.<sup>144</sup> The ability of DCMs to recover and resume trading promptly in the event of a disruption of their operations is highly important to the U.S. economy. Ensuring the resilience of the automated systems of DCMs is a vitally important

<sup>144</sup> These figures derived from Bank for International Settlements, BIS Quarterly Review, June 2010, Page A121, Table 19 at <http://www.bis.org/statistics/otcder/dt1920a.pdf>; see also, Bureau of Economic Analysis news release, BEA 10–47, issued September 30, 2010 at <http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm>.

<sup>139</sup> See 7 U.S.C. 7(d)(17).

<sup>140</sup> 17 CFR 1.31(a)(1).

<sup>141</sup> Compare 7 USC 7(d)(17) with Section 5(d)(18) of the CEA as amended by the Dodd-Frank Act (emphasis added).

part of the Commission's mission, and will be crucial to the robust and transparent systemic risk management framework established by the Dodd-Frank Act. DCM compliance with generally accepted standards and best practices with respect to the development, operation, reliability, security and capacity of automated systems can reduce the frequency and severity of automated system security breaches or functional failures, thereby augmenting efforts to mitigate systemic risk. Notice to the Commission concerning systems malfunctions, systems security incidents, or any events leading to the activation of a DCM's business continuity-disaster recovery ("BC-DR") plan will assist the Commission's oversight and its ability to assess systemic risk levels. It would present unacceptable risks to the U.S. financial system if futures and swaps markets that comprise critical components of the world financial system were to become unavailable for an extended period of time for any reason, and adequate system safeguards are crucial to mitigation of such risks.

Based on the aforementioned, the rules proposed under § 38.1051 would require a DCM's program of risk analysis and oversight to address five categories of risk analysis and oversight, including information security; BC-DR planning and resources, capacity and performance planning; systems operations; systems development and quality assurance; and physical security and environmental controls. The proposed rules specifically would require each DCM to maintain a BC-DR plan and BC-DR resources sufficient to enable resumption of trading and of all of the responsibilities and obligations of the DCM during the next business day following any disruption of its operations, either through sufficient infrastructure and personnel resources of its own or through sufficient contractual arrangements with other DCMs or disaster recovery service providers. The proposed rules also would require each DCM to notify Commission staff of various system security-related events; to provide relevant documents to the Commission; and to conduct regular, periodic, objective testing and review of its automated systems. Moreover, the proposed rules would require each DCM, to the extent practicable, to coordinate its BC-DR plan with those of the members and market participants upon whom it depends to provide liquidity, to initiate coordinated testing of such plans, and to take into account in its own BC-DR plan, the BC-DR

plans of relevant telecommunications, power, water, and other essential service providers.

#### 21. Subpart V—Financial Resources

The Dodd-Frank Act added new Core Principle 21. This core principle requires that a DCM must have adequate financial resources to discharge its responsibilities. The new core principle also requires that boards of trade must maintain financial resources sufficient to cover operating costs for a period of at least one year, calculated on a rolling basis.

The Commission notes that a DCM is the first entity in the trading process to ensure that trading occurs in a liquid, fair, and financially secure trading facility. For instance, a DCM must have, among other things, adequate trade practice and market surveillance, disciplinary, recordkeeping, and alternate dispute resolution programs in place in order to comply with the relevant core principles. In order to fulfill these responsibilities, a DCM must have appropriate minimum financial resources on hand and on an ongoing basis to sustain operations for a reasonable period of time. Furthermore, DCMs must have sufficient resources at any given time to allow them, if necessary, to close out trading in a manner not disruptive to the market.

Proposed § 38.1101 sets out financial resource requirements for DCMs, to implement new Core Principle 21. Under proposed § 38.1101, DCMs that also operate as DCOs are also subject to the financial resource requirements for DCOs in proposed § 39.11.<sup>145</sup>

##### i. Proposed § 38.1101 (a)—General Requirements

Proposed § 38.1100 recites the language of Core Principle 21, as set forth in Section 5(d)(21) of the CEA, as amended by the Dodd-Frank Act. Proposed § 38.1101(a)(1) and (3) would require DCMs to maintain sufficient financial resources to cover operating costs for at least one year, calculated on a rolling basis—i.e., at all times. The DCM must have sufficient financial resources to cover operating costs for at

<sup>145</sup> Commission regulation § 39.11 establishes requirements that a DCO will have to meet in order to comply with DCO Core Principle B (Financial Resources), as amended by the Dodd-Frank Act. Amended Core Principle B requires a DCO to possess financial resources that, at a minimum, exceed the total amount that would enable the DCO to meet its financial obligations to its clearing members notwithstanding a default by the clearing member creating the largest financial exposure for the DCO in extreme but plausible conditions; and enable the DCO to cover its operating costs for a period of 1 year, as calculated on a rolling basis. See 75 FR 63113, Oct. 14, 2010.

least one year from any particular point in time. The one year period is required under the amended core principle, and the Commission considers one year an appropriate timeframe given the potential need to allow contracts to expire and to allow the DCM's business to wind down in an orderly fashion. The Commission believes that this requirement will provide a clear baseline for financial resources, thus enhancing the financial integrity of the markets.<sup>146</sup>

The one-year period also is consistent with established accounting standards, under which an entity's ability to continue as a going concern comes into question if there is evidence that the entity may be unable to continue to meet its obligations in the next 12 months without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions.<sup>147</sup>

##### ii. Proposed § 38.1101(b)—Types of Financial Resources

Under proposed § 38.1101(b), financial resources available to DCMs to satisfy the applicable financial requirements would include the DCM's own capital (assets in excess of liabilities) and any other financial resource deemed acceptable by the Commission. A DCM would be able to request an informal interpretation from Commission staff on whether a particular financial resource would be acceptable to the Commission. The Commission invites commenters to recommend particular financial resources for inclusion in the final regulation.

##### iii. Proposed § 38.1101(c)—Computation of Financial Resource Requirement

Proposed § 38.1101(c) would require a DCM at the end of each fiscal quarter to make a reasonable calculation of the financial resources it needs to meet the

<sup>146</sup> Some foreign regulatory authorities already have similar requirements for the equivalent entities they regulate. For example, the UK Financial Services Authority's ("FSA") recognition requirements for UK recognized investment exchanges and UK recognized clearing houses (collectively, "UK recognized bodies") include the maintenance of financial resources sufficient to ensure that the UK recognized body would be able to complete an orderly closure or transfer of its business without being prevented from doing so by insolvency or lack of available funds. Section 2.3.7 of the FSA Recognition Requirements calls for a UK recognized body to have at all times liquid financial assets amounting to at least six months' operating costs and net capital of at least that amount.

<sup>147</sup> See American Institute of Certified Public Accountants Auditing Standards Board Statement of Auditing Standards No. 59, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, as amended.



requirements of proposed § 38.1101(b). In the first instance, the DCM would have reasonable discretion in determining a methodology it uses to make the calculation. However, the Commission may review the methodology and require changes as appropriate.

iv. Proposed § 38.1101(d)—Valuation of Financial Resources

Proposed § 38.1101(d) would require DCMs, no less frequently than at the end of each fiscal quarter, to calculate the current market value of each financial resource used to meet their obligations under these proposed rules. Additionally, the DCMs would be required to perform the valuation at other times as appropriate. This provision is designed to address the need to update valuations in circumstances where there may have been material fluctuations in market value that could impact a DCM's ability to meet its obligations on a rolling basis as required by proposed § 38.1101(a). When valuing a financial resource, a DCM would be required to reduce the value, as appropriate, to reflect any market or credit risk specific to that particular resource, *i.e.*, apply a haircut.<sup>148</sup> The Commission would permit each DCM to exercise its discretion in determining the applicable haircuts. However, such haircuts are subject to Commission review and must be acceptable to the Commission.

v. Proposed § 38.1101(e)—Liquidity of Financial Resources

Proposed § 38.1101(e) would require DCMs to maintain unencumbered liquid financial assets, such as cash or highly liquid securities, equal to at least six months' operating costs. The Commission believes that having six months' worth of unencumbered liquid financial assets would give a DCM time to liquidate the remaining financial assets it would need to continue operating for the last six months of the required one-year period. If a DCM does not have six months' worth of unencumbered liquid financial assets, it would be allowed to use a committed line of credit or similar facility to satisfy this requirement.

The Commission notes that a committed line of credit or similar facility is not listed in proposed § 38.1101(b) as a financial resource available to a DCM to satisfy the requirements of proposed § 38.1101(a). A DCM may only use a committed line

of credit or similar facility to meet the liquidity requirements set forth in proposed § 38.1101(e).

vi. Proposed § 38.1101(f)—Reporting Requirements

Under proposed § 38.1101(f), at the end of each fiscal quarter, or at any time upon Commission request, DCMs would be required to report to the Commission: (i) the amount of financial resources necessary to meet the requirements set forth in the regulation; and (ii) the value of each financial resource available to meet those requirements. A DCM would also have to provide the Commission with a financial statement, including the balance sheet, income statement, and statement of cash flows, of the DCM or of its parent company (if the DCM does not have an independent financial statement and the parent company's financial statement is prepared on a consolidated basis).

Proposed § 38.1101(f) requires a DCM to provide the Commission with sufficient documentation that explains the methodology it used to calculate its financial requirements and the basis for its determinations regarding valuation and liquidity. The DCM also must provide copies of any agreements establishing or amending a credit facility, insurance coverage, or any similar arrangement that evidences or otherwise supports its conclusions. The sufficiency of the documentation would be determined by the Commission in its sole discretion. The DCM would have 17 business days<sup>149</sup> from the end of the fiscal quarter to file the report, but would also be able to request an extension of time from the Commission.

The Commission invites comments on all these proposed rules relating to requirements for financial resources for DCMs.

22. Subpart W—Diversity of Boards of Directors

The Dodd-Frank Act added new Core Principle 22, requiring that publicly traded DCMs must endeavor to recruit individuals to serve on their board of directors from among a broad and culturally diverse pool of qualified candidates. This release proposes to codify the statutory text of the core principle in proposed § 38.1150. This core principle will be addressed in a forthcoming release that is expected to be completed by the statutory deadline of July 15, 2011.

23. Subpart X—Securities and Exchange Commission

The Dodd-Frank Act added new Core Principle 23, requiring that DCMs keep any records relating to swaps defined in CEA Section 1a(47)(A)(v), as amended by the Dodd-Frank Act, open to inspection and examination by the Securities and Exchange Commission ("SEC").<sup>150</sup> Consistent with the text of this core principle, the Commission proposes guidance under part 38 that provides that each DCM should have arrangements and resources for collecting and maintaining accurate records pertaining to any swap agreements defined in section 1a(47)(A)(v) of the amended CEA.

Proposed § 38.1201 refers applicants and DCMs to the guidance in Appendix B to part 38 for purposes of demonstrating to the Commission their compliance with the requirements of Proposed § 38.1200, which codifies the text of the core principle.

III. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA")<sup>151</sup> requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. The rules adopted herein will affect designated contract markets. The Commission has previously established certain definitions of "small entities" to be used by the Commission in evaluating the impact of its rules on small entities in accordance with the RFA.<sup>152</sup> The Commission previously determined that designated contract markets are not small entities for the purpose of the RFA.<sup>153</sup> Therefore, the Chairman, on behalf of the Commission, pursuant to 5 U.S.C. 605(b) certifies that the proposed rules will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

This proposed rulemaking contains information collection requirements. The Paperwork Reduction Act (PRA)<sup>154</sup> imposes certain requirements on Federal agencies in connection with their conducting or sponsoring any collection of information as defined by the PRA. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The Commission is

<sup>150</sup> 7 U.S.C. 7; see also Section 5(d)(23) of the CEA, as amended by the Dodd-Frank Act.

<sup>151</sup> 5 U.S.C. 601 *et seq.*

<sup>152</sup> 47 FR 18618–21, Apr. 30, 1982.

<sup>153</sup> *Id.*

<sup>154</sup> 44 U.S.C. 3501 *et seq.*

<sup>148</sup> A "haircut" is a deduction taken from the value of an asset to reserve for potential future adverse price movements in such asset.

<sup>149</sup> This filing deadline is consistent with the deadline imposed on FCMs for the filing of monthly financial reports. See 17 CFR 1.10(b).

proposing to amend Collection 3038–0052 to allow for an increase in response hours for the proposed rulemaking amending part 38, which captures associated proposed amendments to rules 1.52 and 16.01, as required under the Dodd-Frank Act.<sup>155</sup> The Commission therefore is submitting this proposal to the Office of Management and Budget (OMB) for its review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for this collection is “Part 38—Designated Contract Markets” (OMB Control number 3038–0052). Responses to this collection of information would be mandatory. The Commission will protect proprietary information according to the Freedom of Information Act (FOIA) and 17 CFR part 145, “Commission Records and Information.” In addition, section 8(a)(1) of the CEA strictly prohibits the Commission, unless specifically authorized by the Act, from making public “data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers.”<sup>156</sup> The Commission is also required to protect certain information contained in a government system of records according to the Privacy Act of 1974.<sup>157</sup>

#### 1. Additional Information Provided by Designated Contract Markets

The proposed rules require each respondent to file information with the Commission. For instance, contract markets must file applications and supporting documents and information with the Commission for designation pursuant to Commission rule 38.3. Designated contract markets must either request approval or certify rules and products with the Commission pursuant to Commission rule 38.4. Designated contract markets must disclose information related to prices, volume, open interest and certain trading information pursuant to Core Principle 8 (Daily Publication of Trading Information).<sup>158</sup>

Commission staff previously estimated 300 hours average response time from each respondent for this collection of information for designation and compliance purposes pursuant to part 38. Based on its experience with administering registered entities’ submission requirements since implementation of the Commodity

Futures Modernization Act of 2000,<sup>159</sup> Commission staff believes that the response time for designation and compliance would generally increase by 10% with the implementation of swaps trading on designated contract markets pursuant to Section 723(a)(3) of the Dodd-Frank Act and the addition of new core principles with which designated contract markets must comply. Commission staff estimates that it would receive filings from 17 respondents.<sup>160</sup> Accordingly, the additional burden in terms of hours would be 30 additional hours per respondent and 510 additional hours annually for all respondents for designation and compliance.

In addition to the general increase noted above, pursuant to the proposed rulemaking, respondents are subject to new Core Principle 21 (Financial Resources) that requires the respondent to have adequate financial, operational and managerial resources.<sup>161</sup> In order to demonstrate compliance with Core Principle 21, each respondent will need to file specific reports to the Commission on a quarterly basis, which would result in four quarterly responses per respondent per year. Commission staff estimates that each respondent would expend 10 hours to prepare each filing required under the proposed regulations. As noted above, Commission staff estimates that it would receive filings from 17 respondents. Accordingly, the additional burden in terms of hours would be 40 additional hours annually per respondent and 680 additional hours annually for all respondents to comply with Core Principle 21.

Commission staff estimates that respondents could expend up to an additional \$3,640 annually based on an hourly wage rate of \$52 (30 hours + 40 hours × \$52) to comply with the proposed rules. This would result in an aggregated additional cost of \$61,880 per annum (17 respondents × \$3,640).

*OMB Control Number 3038–005.*

*Estimated Number of Respondents:* 17.

*Quarterly Responses by Each Respondent:* 4.

*Total Quarterly Responses by Each Respondent:* 68.

*Estimated Additional Average Hours per Response:* 70.

*Aggregate Annual Hourly Reporting Burden:* 1190.

#### 2. Information Collection Comments

Copies of the submission from the Commission to OMB are available by visiting RegInfo.gov. The Commission will consider public comments on this proposed collection of information in:

(1) Evaluating whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information will have a practical use;

(2) Evaluating the accuracy of the estimated burden of the proposed collection of information, including the degree to which the methodology and the assumptions that the Commission employed were valid;

(3) Enhancing the quality, utility, and clarity of the information proposed to be collected; and

(4) Minimizing the burden of the proposed information collection requirements on designated clearing organizations, designated contract markets, and swap execution facilities, including through the use of appropriate automated, electronic, mechanical, or other technological information collection techniques, e.g., permitting electronic submission of responses.

Organizations and individuals desiring to submit comments on the proposed information collection requirements should contact the Office of Information and Regulatory Affairs, Office of Management and Budget, by fax at (202) 395–6566 or by e-mail at [OIRASubmission@omb.eop.gov](mailto:OIRASubmission@omb.eop.gov). Please provide the Commission with a copy of submitted comments so that they may be summarized and addressed in the final rulemaking. Refer to the Addresses section of this notice of proposed rulemaking for comment submission instructions to the Commission.

OMB is required to make a decision concerning the proposed information collection requirements between 30 and 60 days after publication of this Release in the **Federal Register**. Therefore, a comment to OMB is best assured of receiving full consideration if OMB receives it within 30 days of publication of this Release. Nothing in the foregoing affects the deadline enumerated above for public comment to the Commission on the proposed rules.

#### C. Cost Benefit Analysis

Section 15(a) of the CEA<sup>162</sup> requires that the Commission consider the costs and benefits of its actions before issuing a regulation under the Act. By its terms, Section 15(a) does not require the Commission to quantify the costs and

<sup>155</sup> Dodd Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

<sup>156</sup> 7 U.S.C. 12.

<sup>157</sup> 5 U.S.C. 552a.

<sup>158</sup> See Section 735(b) of the Dodd-Frank Act.

<sup>159</sup> Public Law 106–554, 114 Stat. 2763 (2000).

<sup>160</sup> The number of designated contract markets increased from 13 to 17 since the last amendment to Collection 3038–0052.

<sup>161</sup> See section 735(b) of the Dodd-Frank Act.

<sup>162</sup> 7 U.S.C. 19(a).

benefits of a new rule or determine whether the benefits of the rulemaking outweigh its costs; rather, Section 15(a) requires the Commission to “consider” the costs and benefits of its actions.

Section 15(a) of the CEA further specifies that costs and benefits shall be evaluated in light of five broad areas of market and public concern:

(1) Protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. Accordingly, the Commission could, in its discretion, give greater weight to any one of the five considerations and could, in its discretion, determine that, notwithstanding its costs, a particular rule was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the CEA.

#### Summary of Proposed Requirements

The proposed rulemaking would change the criteria applicants for designation as a contract market must meet by: (1) Eliminating all of the existing eight designation criteria and incorporating those criteria into various DCM core principles; (2) revising, in some instances, the wording of the 18 pre-existing DCM core principles; and (3) adding five additional DCM core principles. In addition to revising the DCM core principles, the Dodd-Frank Act requires that the trading or processing of clearable swaps must occur only on a registered DCM or SEF.<sup>163</sup> This rulemaking will implement, in part 38 of the Commission’s regulations, these amended provisions of the Act relevant to DCMs. Specific provisions include a proposal to replace guidance and acceptable practices associated with certain core principles with regulations. The Commission also is proposing several procedural changes for new applications for designation as a contract market, including the elimination of the expedited approval procedures and the creation of a DCM application form. Under the proposal, the timing of reviews of designation applications would be governed only by the 180-day statutory review period.

#### Costs

As highlighted by recent events in the global credit markets, transacting of swaps in unregulated, over-the-counter markets does not contribute to the goal

of stability in the broader financial markets. The public would continue to be at risk to such financial instability if certain derivatives were allowed to trade over the counter rather than on regulated exchanges. Designated contract markets that determine to list swaps for trading will be subject to core principles for trading of swaps just as they are for futures contracts. If swaps were allowed to continue to be transacted bilaterally, rather than on the centralized market of a DCM, price discovery and transparency in the swaps markets would continue to be inhibited.

Under the proposed rulemaking, designated contract markets will be required to comply with five additional core principles for trading futures and option contracts. Moreover, designated contract markets that determine to list standardized swaps for trading will be required to comply with the same core principles as for trading futures contracts. These procedures are mandatory pursuant to the Dodd-Frank Act and any additional costs associated with these procedures are required by the implementation of the Dodd-Frank Act. The Commission is also proposing to replace guidance and acceptable practices associated with certain core principles with regulations. While these new regulations generally codify existing industry practice, bringing their procedures into full compliance with these new regulations may impose some costs on DCMs.

Regarding new applications for designation as a contract market, the Commission is proposing several procedural changes, including the elimination of the expedited approval procedures, such that the timing of such reviews would be governed only by the 180-day statutory review period. This may impose costs on DCM applicants that may have to wait longer for designation than under current procedures. However, in light of the difficulties in submitting a complete application under the expedited procedures, few DCMs have been eligible for designation under the expedited procedures, so these costs should be limited.

#### Benefits

The Commission believes that the benefits of the rulemaking are significant. The proposed regulations provide for the transacting of swaps on DCMs. DCMs will compete with swap execution facilities to list new standardized swaps contracts, while certain customized swaps will continue to transact bilaterally. This competition will benefit the marketplace. Providing

market participants with the ability to trade standardized swaps openly and competitively additionally will provide market participants with enhanced price transparency resulting in greater protection of market participants and the public.

The proposed regulations also require DCMs that determine to list swaps for trading will have to coordinate with DCOs so that the swaps may be listed swaps for clearing. This will subject the swaps to the DCO’s risk management and margining procedures, which addresses the consideration of sound risk management practices and will add to the financial integrity of the swaps markets.

The proposed regulations eliminate all of the existing eight designation criteria and incorporate those criteria into various existing DCM core principles. The proposed regulations additionally implement five new core principles, specifically Core Principle 13 (Disciplinary Procedures), Core Principle 20 (System Safeguards), Core Principle 21 (Financial Resources), Core Principle 22 (Diversity of Boards of Directors), and Core Principle 23 (Securities and Exchange Commission). The proposed rules also modify existing core principles. For example, newly amended Core Principle 9 (Execution of Transactions) requires the board of trade to provide a competitive, open and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market. These changes will benefit the public by further enhancing the transparency and integrity of futures and options markets as well as swap markets on DCMs.

Further, the Commission proposes to replace guidance and acceptable practices associated with certain core principles with regulations. This will have the benefit to DCMs and the public of providing greater regulatory certainty. Finally the changes to the procedures for applying for contract market designation will benefit new applicants by improving the workability and efficiency of the application process.

#### Public Comment

The Commission invites public comment on its cost-benefit considerations. Commenters are also invited to submit any data or other information that they may have quantifying or qualifying the costs and benefits of the Proposal with their comment letters.

<sup>163</sup> See section 723 of Dodd-Frank Act.

#### IV. Text of Proposed Rules

##### List of Subjects

###### 17 CFR Part 1

Commodity futures, Designated contract markets, Minimum financial requirements for intermediaries, Reporting and recordkeeping requirements.

###### 17 CFR Part 16

Commodity futures, Reporting and Recordkeeping requirements.

###### 17 CFR Part 38

Block transaction, Commodity futures, Designated contract markets, Reporting and Recordkeeping requirements, Transactions off the centralized market.

For the reasons stated in the preamble, and under the authority of 7 U.S.C. 1, *et seq.*, the Commodity Futures Trading Commission proposes to amend 17 CFR parts 1, 16 and 38 as follows:

#### PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. Revise the authority citation for part 1 to read as follows:

**Authority:** 7 U.S.C. 1a, 2, 5, 6, 6a, 6b, 6c, 6d, 6e, 6f., 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 7, 7a–2, 7b, 8, 9, 12, 12a, 12c, 13a, 13a–1, 16, 19, 21, 23 and 24, as amended by Pub. L. No. 111–203, 124 Stat 1376.

##### § 1.38 [Removed and Reserved]

2. Remove and reserve § 1.38.
3. Revise § 1.52 to read as follows:

##### § 1.52 Self-regulatory organization adoption and surveillance of minimum financial requirements.

(a) Each self-regulatory organization must adopt rules prescribing minimum financial and related reporting requirements for members who are registered futures commission merchants, registered retail foreign exchange dealers, or registered introducing brokers. The self-regulatory minimum financial and related reporting requirements must be the same as, or more stringent than, the requirements contained in §§ 1.10 and 1.17 of this chapter, for futures commission merchants and introducing brokers, and §§ 5.7 and 5.12 of this chapter for retail foreign exchange dealers; Provided, however, a self-regulatory organization may permit its member registrants that are registered with the Securities and Exchange Commission as securities brokers or dealers to file (in accordance with § 1.10(h) of this chapter) a copy of their Financial and Operational Combined Uniform Single Report under the

Securities Exchange Act of 1934, Part II, Part IIA, or Part II CSE, in lieu of Form 1–FR. The definition of adjusted net capital must be the same as that prescribed in § 1.17(c) of this chapter for futures commission merchants and introducing brokers, and § 5.7(b)(2) of this chapter for futures commission merchants offering or engaging in retail forex transactions and for retail foreign exchange dealers.

(b) Each self-regulatory organization must establish and operate a supervisory program for the purpose of assessing whether each member registrant is in compliance with the applicable self-regulatory organization and Commission rules and regulations governing minimum net capital and related financial requirements, the obligation to segregate customer funds, financial reporting requirements, recordkeeping requirements, and sales practice and other compliance requirements. The supervisory program also must address the following elements:

(1) *Adequate levels and independence of audit staff.* A self-regulatory organization must maintain staff of an adequate size, training, and experience to effectively implement a supervisory program. Staff of the self-regulatory organization, including officers, directors and supervising committee members, must maintain independent judgment and its actions must not impair its independence nor appear to impair its independence in matters related to the supervisory program. The self-regulatory organization must provide annual ethics training to all staff with responsibilities for the supervisory program.

(2) *Ongoing surveillance.* A self-regulatory organization's ongoing surveillance of member registrants must include the review and analysis of financial reports and regulatory notices filed by member registrants with the designated self-regulatory organization.

(3) *High-risk firms.* A self-regulatory organization's supervisory program must include procedures for identifying member registrants that are determined to pose a high degree of potential financial risk, including the potential risk of loss of customer funds. High-risk member registrants must include firms experiencing financial or operational difficulties, failing to meet segregation or net capital requirements, failing to maintain current books and records, or experiencing material inadequacies in internal controls. Enhanced monitoring for high risk firms should include, as appropriate, daily review of net capital, segregation, and secured calculations, to

assess compliance with self-regulatory and Commission requirements.

(4) *On-site examinations.* (i) A self-regulatory organization must conduct routine periodic on-site examinations of member registrants. Member futures commission merchants and retail foreign exchange dealers must be subject to on-site examinations no less frequently than once every eighteen months. A self-regulatory organization may establish a risk-based method of establishing the scope of each on-site examination, *provided however*, that the scope of each on-site examination of a futures commission merchant or retail foreign exchange dealer must include an assessment of whether the registrant is in compliance with applicable Commission and self-regulatory organization minimum capital and customer fund protection requirements, recordkeeping, and reporting requirements.

(ii) A self-regulatory organization must establish the frequency of on-site examinations of member introducing brokers that do not operate pursuant to guarantee agreements with futures commission merchants or retail foreign exchange dealers using a risk-based approach, *provided however*, that each introducing broker is subject to an on-site examination no less frequently than once every three years.

(iii) A self-regulatory organization must conduct on-site examinations of member registrants in accordance with uniform audit programs and procedures that have been submitted to the Commission.

(5) *Adequate documentation.* A self-regulatory organization must adequately document all aspects of the operation of the supervisory program, including the conduct of risk-based scope setting and the risk-based surveillance of high-risk member registrants, and the imposition of remedial and punitive action(s) for material violations.

(c) Any two or more self-regulatory organizations may file with the Commission a plan for delegating to a designated self-regulatory organization, for any registered futures commission merchant, retail foreign exchange dealer, or introducing broker that is a member of more than one such self-regulatory organization, the responsibility of:

(1) Monitoring and auditing for compliance with the minimum financial and related reporting requirements adopted by such self-regulatory organizations and the Commission in accordance with paragraphs (a) and (b) of this section; and

(2) Receiving the financial reports necessitated by such minimum financial and related reporting requirements.

(d) Any plan filed under this section may contain provisions for the allocation of expenses reasonably incurred by the designated self-regulatory organization among the self-regulatory organizations participating in such a plan.

(e) A plan's designated self-regulatory organization must report to:

(1) That plan's other self-regulatory organizations any violation of such other self-regulatory organizations' rules and regulations for which the responsibility to monitor, audit or examine has been delegated to such designated self-regulatory organization under this section; and

(2) The Commission any violation of a self-regulatory organization's rules and regulations or any violation of the Commission's regulations for which the responsibility to monitor, audit or examine has been delegated to such designated self-regulatory organization under this section.

(f) The self-regulatory organizations may, among themselves, establish programs to provide access to any necessary financial or related information.

(g) After appropriate notice and opportunity for comment, the Commission may, by written notice, approve such a plan, or any part of the plan, if it finds that the plan, or any part of it:

(1) Is necessary or appropriate to serve the public interest;

(2) Is for the protection and in the interest of customers or option customers;

(3) Reduces multiple monitoring and multiple auditing for compliance with the minimum financial rules of the self-regulatory organizations submitting the plan of any futures commission merchant, retail foreign exchange dealer, or introducing broker that is a member of more than one self-regulatory organization;

(4) Reduces multiple reporting of the financial information necessitated by such minimum financial and related reporting requirements by any futures commission merchant, retail foreign exchange dealer, or introducing broker that is a member of more than one self-regulatory organization;

(5) Fosters cooperation and coordination among the self-regulatory organizations; and

(6) Does not hinder the development of a registered futures association under Section 17 of the Act.

(h) After the Commission has approved a plan, or part thereof, under

§ 1.52(g), a self-regulatory organization relieved of responsibility must notify each of its members that are subject to such a plan:

(1) Of the limited nature of its responsibility for such a member's compliance with its minimum financial and related reporting requirements; and

(2) Of the identity of the designated self-regulatory organization that has been delegated responsibility for such a member.

(i) The Commission may at any time, after appropriate notice and opportunity for hearing, withdraw its approval of any plan, or part thereof, established under this section, if such plan, or part thereof, ceases to adequately effectuate the purposes of Section 4f(b) of the Act or of this section.

(j) Whenever a registered futures commission merchant, a registered retail foreign exchange dealer, or a registered introducing broker holding membership in a self-regulatory organization ceases to be a member in good standing of that self-regulatory organization, such self-regulatory organization must, on the same day that event takes place, give electronic notice of that event to the Commission at its Washington, DC, headquarters and send a copy of that notification to such futures commission merchant, retail foreign exchange dealer, or introducing broker.

(k) Nothing in this section shall preclude the Commission from examining any futures commission merchant, retail foreign exchange dealer, or introducing broker for compliance with the minimum financial and related reporting requirements to which such futures commission merchant, retail foreign exchange dealer, or introducing broker is subject.

(l) In the event a plan is not filed and/or approved for each registered futures commission merchant, retail foreign exchange dealer, or introducing broker that is a member of more than one self-regulatory organization, the Commission may design and, after notice and opportunity for comment, approve a plan for those futures commission merchants, retail foreign exchange dealers, or introducing brokers that are not the subject of an approved plan (under paragraph (g) of this section), delegating to a designated self-regulatory organization the responsibilities described in paragraph (c) of this section.

#### **PART 16—REPORTS BY CONTRACT MARKETS AND SWAP EXECUTION FACILITIES**

4. The authority citation for part 16 is revised to read as follows:

**Authority:** 7 U.S.C. 2, 6a, 6c, 6g, 6i, and 7, and 7b–3, as amended by Pub. L. 111–203, 124 Stat. 1376.

5. The heading for part 16 is revised to read as set forth above.

6. Revise § 16.01 to read as follows:

#### **§ 16.01 Publication of market data on futures, swaps and options thereon: Trading volume, open contracts, prices, and critical dates.**

(a) *Trading volume and open contracts.* (1) Each reporting market, as defined in part 15 of this chapter, must record for each business day the following information separately:

(i) For futures, by commodity and by futures expiration date;

(ii) For options by underlying futures contracts for options on futures contracts or by underlying physical for options on physicals, and by put, by call, by expiration date and by strike price;

(iii) For swaps or class of swaps, by product type and by term life of the swap; and

(iv) For swaptions or class of swaptions, by underlying swap contracts for options on swap contracts or by underlying physical for swaptions on physicals, and by put, by call, by expiration date and by strike price.

(2) Volume for swaps and swaptions shall be reported in terms of contracts for standard-sized contracts (i.e., contracts with a set contract size for all contracts) or in terms of notional value for non-standard-sized contracts (i.e., contracts whose contract size is not set and can vary for each transaction):

(i) The option delta, where a delta system is used;

(ii) The total gross open contracts for futures, excluding those contracts against which delivery notices have been stopped;

(iii) For futures products that specify delivery, open contracts against which delivery notices have been issued on that business day;

(iv) The total volume of trading, excluding transfer trades or office trades;

(v) The total volume of futures/options/swaps/swaptions exchanged for commodities or for derivatives positions that are included in the total volume of trading; and

(vi) The total volume of block trades included in the total volume of trading.

(b) *Prices.* (1) Each reporting market must record the following information separately:

(i) For futures, by commodity and by futures expiration,

(ii) For options, by underlying futures contracts for options on futures contracts or by underlying physical for

options on physicals, and by put, by call, by expiration date and by strike price,

(iii) For swaps, by product type and contract month or term life of the swap, and

(iv) For swaptions or class of swaptions, by underlying swap contracts for options on swap contracts or by underlying physical for swaptions on physicals, and by put, by call, by expiration date and by strike price.

(2) Each reporting market must record for the trading session and for the opening and closing periods of trading as determined by each reporting market:

(i) The opening and closing prices of each futures, option, swap or swaption.

(ii) The price that is used for settlement purposes, if different from the closing price.

(iii) The lowest price of a sale or offer, whichever is lower, and the highest price of a sale or bid, whichever is higher, that the reporting market reasonably determines accurately reflects market conditions. Bids and offers vacated or withdrawn shall not be used in making this determination. A bid is vacated if followed by a higher bid or price and an offer is vacated if followed by a lower offer or price.

(3) If there are no transactions, bids, or offers during the opening or closing periods, the reporting market may record as appropriate:

(i) The first price (in lieu of opening price data) or the last price (in lieu of closing price data) occurring during the trading session, clearly indicating that such prices are the first and last prices; or

(ii) Nominal opening or nominal closing prices that the reporting market reasonably determines to accurately reflect market conditions, clearly indicating that such prices are nominal.

(4) Additional information. Each reporting market must record the following information with respect to transactions in commodity futures, commodity options, swaps or swaptions on that reporting market:

(i) The method used by the reporting market in determining nominal prices and settlement prices; and

(ii) If discretion is used by the reporting market in determining the opening and/or closing ranges or the settlement prices, an explanation that certain discretion may be employed by the reporting market and a description of the manner in which that discretion may be employed. Discretionary authority must be noted explicitly in each case in which it is applied (for example, by use of an asterisk or footnote).

(c) *Critical dates.* Each reporting market must report to the Commission, for each futures contract, the first notice date and the last trading date, and for each option contract, the expiration date in accordance with paragraph (d) of this section.

(d) *Form, manner and time of filing reports.* Unless otherwise approved by the Commission or its designee, reporting markets must submit to the Commission the information specified in paragraphs (a)(2), (b), and (c) of this section as follows:

(1) Using the format, coding structure and electronic data transmission procedures approved in writing by the Commission or its designee; *provided however*, that the information must be made available to the Commission or its designee in hard copy upon request;

(2) When each such form of the data is first available, but not later than 7 a.m. on the business day following the day to which the information pertains for the delta factor and settlement price and not later than 12 p.m. for the remainder of the information. Unless otherwise specified by the Commission or its designee, the stated time is U.S. eastern standard time for information concerning markets located in that time zone, and U.S. central time for information concerning all other markets; and

(3) For information on reports to the Commission for swap or swaption contracts, refer to part 20 of this chapter.

(e) *Publication of recorded information.* (1) Reporting markets must make the information in paragraph (a) of this section readily available to the news media and the general public without charge, in a format that readily enables the consideration of such data, no later than the business day following the day to which the information pertains. The information in paragraphs (a)(2)(iv) through (vi) of this section shall be made readily available in a format that presents the information together.

(2) Reporting markets must make the information in paragraphs (b)(2) and (3) of this section readily available to the news media and the general public, and the information in paragraph (b)(4)(ii) of this section readily available to the general public, in a format that readily enables the consideration of such data, no later than the business day following the day to which the information pertains. Information in paragraph (b)(4)(i) of this section must be made available in the registered entity's rulebook, which is publicly accessible on its Web site.

## PART 38—DESIGNATED CONTRACT MARKETS

7. Revise the authority citation for part 38 to read as follows:

**Authority:** 7 U.S.C. 2, 4c., 6, 6a, 6d, 6e, 6f, 6g, 6i, 6j, 6k, 6l, 6m, 6n, 7, 7a–2, 7b, 7b–1, 7b–3, 8, 9, 15, and 21 as amended by Pub. L. 111–203, 124 Stat. 1376.

8. Designate existing §§ 38.1 through 38.6 as subpart A under the following subpart heading:

### Subpart A—General Provisions

\* \* \* \* \*

#### § 38.1 [Amended]

9. Amend § 38.1 by removing the reference “Parts 36 or 37 of this chapter” and adding in its place the reference “parts 37 or 49 of this chapter”.

10. Revise § 38.2 to read as follows:

#### § 38.2 Applicable provisions.

A designated contract market, the contract market's operator and transactions traded on or through a designated contract market under Section 5 of the Act shall comply with the requirements of this part 38, §§ 1.3, 1.12(e), 1.31, 1.37(c)–(d), 1.52, 1.59(d), 1.60, 1.63(c), 1.67, 33.10, part 9, parts 15 through 21, part 40, part 41, part 43, part 45, part 46, part 49, part 151, and part 190 of this chapter, including any related definitions and cross-referenced sections.

11. Revise § 38.3 to read as follows:

#### § 38.3 Procedures for designation.

(a) *Application procedures.* (1) A board of trade seeking designation as a contract market must file electronically Application Form DCM provided in Appendix A of this part, with the Secretary of the Commission at its Washington, DC headquarters at [submissions@cftc.gov](mailto:submissions@cftc.gov) and the Division of Market Oversight at [DMOSubmissions@cftc.gov](mailto:DMOSubmissions@cftc.gov). The Commission will review the application for designation as a contract market pursuant to the 180-day timeframe and procedures specified in Section 6(a) of the Act. The Commission shall approve or deny the application or, if deemed appropriate, designate the applicant as a contract market subject to conditions.

(2) The application must include information sufficient to demonstrate compliance with the core principles specified in Section 5(d) of the Act. Application Form DCM consists of instructions, general questions and a list of Exhibits (documents, information and evidence) required by the Commission in order to determine whether an applicant is able to comply with the core principles. An application will not

be considered to be materially complete unless the applicant has submitted, at a minimum, the Exhibits as required in Application Form DCM. If the application is not materially complete, the Commission shall notify the applicant that the application will not be deemed to have been submitted for purposes of the 180-day review period set forth in paragraph (a)(1) of this section.

(3) The applicant must identify with particularity any information in the application that will be subject to a request for confidential treatment pursuant to § 145.9 of this chapter.

(4) Section 40.8 of this chapter sets forth those sections of the application that will be made publicly available, notwithstanding a request for confidential treatment pursuant to § 145.9 of this chapter.

(5) If any information contained in the application or in any Exhibit is or becomes inaccurate for any reason, an amendment to the application or a submission filed under part 40 of this chapter must be filed promptly correcting such information.

(b) *Reinstatement of dormant designation.* Before listing or relisting products for trading, a dormant designated contract market as defined in § 40.1 of this chapter must reinstate its designation under the procedures of paragraphs (a)(1) and (a)(2) of this section; provided, however, that an application for reinstatement may rely upon previously submitted materials that still pertain to, and accurately describe, current conditions.

(c) *Delegation of authority.* (1) The Commission hereby delegates, until it orders otherwise, to the Director of the Division of Market Oversight or such other employee or employees as the Director may designate from time to time, upon consultation with the General Counsel or the General Counsel's delegate, authority to notify the applicant seeking designation under Section 6(a) of the Act that the application is materially incomplete and the running of the 180-day period is stayed.

(2) The Director may submit to the Commission for its consideration any matter that has been delegated in this paragraph.

(3) Nothing in this paragraph prohibits the Commission, at its election, from exercising the authority delegated in paragraph (c)(1) of this section.

(d) *Request for transfer of designation.* (1) *Request for transfer of designation, listed contracts and open interest.* A designated contract market that wants to request the transfer of its designation

from its current legal entity to a new legal entity, as a result of a corporate reorganization or otherwise, must file a request with the Commission for approval to transfer the designation, listed contracts and positions comprising all associated open interest. Such request must be filed electronically with the Secretary of the Commission at its Washington, DC headquarters at [submissions@cftc.gov](mailto:submissions@cftc.gov) and the Division of Market Oversight at [DMSUBmissions@cftc.gov](mailto:DMSUBmissions@cftc.gov).

(2) *Timing of submission.* The request must be filed no later than three months prior to the anticipated corporate change; provided that the designated contract market may file a request with the Commission later than three months prior to the anticipated change if the designated contract market does not know and reasonably could not have known of the anticipated change three months prior to the anticipated change. In such event, the designated contract market shall be required to immediately file the request with the Commission as soon as it knows of such change with an explanation as to the timing of the request.

(3) *Required information.* The request shall include the following:

(i) The underlying agreement that governs the corporate change.

(ii) A narrative description of the corporate change, including the reason for the change and its impact on the designated contract market, including its governance, and operations, and its impact on the rights and obligations of market participants holding the open interest positions.

(iii) A discussion of the transferee's ability to comply with the Act, including the core principles applicable to designated contract markets, and the Commission's regulations thereunder.

(iv) The governing documents of the transferee including, but not limited to, articles of incorporation and bylaws.

(v) The transferee's rules marked to show changes from the current rules of the designated contract market.

(vi) A list of contracts, agreements, transactions or swaps for which the designated contract market requests transfer of open interest.

(vii) A representation by the transferee that it:

(A) Will be the surviving corporation and successor-in-interest to the transferor designated contract market and will retain and assume, without limitation, all the assets and liabilities of the transferor;

(B) Will assume responsibility for complying with all applicable provisions of the Act and the Commission's regulations thereunder,

including part 38 and Appendices thereto;

(C) Will assume, maintain and enforce all rules implementing and complying with these core principles, including the adoption of the transferor's rulebook, as amended in the request, and that any such amendments will be submitted to the Commission pursuant to Section 5c(c) of the Act and part 40 of the Commission's regulations; and

(D) Will comply with all self-regulatory responsibilities except if otherwise indicated in the request, and will maintain and enforce all self-regulatory programs.

(viii) A representation by the transferee that upon the transfer:

(A) All open interest in all contracts listed on the transferor will be transferred to and represent equivalent open interest in all such contracts listed on the transferee;

(B) It will assume responsibility for and maintain compliance with product core principles for all contracts previously listed for trading through the transferor, whether by certification or approval; and

(C) That none of the proposed rule changes will affect the rights and obligations of any participant with open positions transferred to it and that the proposed rule changes do not modify the manner in which such contracts are settled or cleared.

(ix) A representation by the transferee that market participants will be notified of all changes to the transferor's rulebook prior to the transfer and will be further notified of the concurrent transfer of the contract market designation and the related transfer of all listed contracts and all associated open interest, to the transferee upon Commission approval and issuance of an order permitting this transfer.

(4) Commission determination. The Commission will review a request as soon as practicable and such request will be approved or denied pursuant to a Commission order and based on the Commission's determination as to the transferee's ability to continue to operate the designated contract market in compliance with the Act and the Commission's regulations thereunder.

(e) *Request for withdrawal of application for designation.* An applicant for designation may withdraw its application submitted pursuant to paragraphs (a)(1) and (a)(2) of this section by filing such a request with the Commission at its Washington, DC headquarters. Withdrawal of an application for designation shall not affect any action taken or to be taken by the Commission based upon actions, activities or events occurring during the

time that the application for designation was pending with the Commission.

(f) *Request for vacation of designation.* A designated contract market may vacate its designation under Section 7 of the Act by filing electronically such a request with the Commission at its Washington, DC headquarters. Vacation of designation shall not affect any action taken or to be taken by the Commission based upon actions, activities or events occurring during the time that the facility was designated by the Commission.

(g) *Requirements for existing designated contract markets.* A board of trade that is designated as a contract market as of [EFFECTIVE DATE OF FINAL RULE], will be considered to be a designated contract market under this section, provided that such existing designated contract market certifies to the Commission in writing that it is in compliance with each of the designated contract market core principles and associated regulations in this part, within 60 days of [EFFECTIVE DATE OF FINAL RULE].

12. In § 38.4, revise paragraphs (a) and (b) to read as follows:

**§ 38.4 Procedures for listing products and implementing designated contract market rules.**

(a) *Request for Commission approval of rules and products.* (1) An applicant for designation, or a designated contract market, may request that the Commission approve under Section 5c(c) of the Act, any or all of its rules and contract terms and conditions, and subsequent amendments thereto, prior to their implementation or, notwithstanding the provisions of Section 5c(c)(2) of the Act, at anytime thereafter, under the procedures of §§ 40.3 or 40.5 of this chapter, as applicable. A designated contract market may label a future, swap or options product in its rules as “Listed for trading pursuant to Commission approval,” if the future, swap or options product and its terms or conditions have been approved by the Commission, and it may label as “Approved by the Commission” only those rules that have been so approved.

(2) Notwithstanding the timeline under §§ 40.3(c) and 40.5(c) of this chapter, the operating rules and terms and conditions of futures, swaps and option products that have been submitted for Commission approval at the same time as an application for contract market designation or an application under § 38.3(b) of this part to reinstate the designation of a dormant designated contract market, as defined in § 40.1 of this chapter, or while one of

the foregoing is pending, will be deemed approved by the Commission no earlier than when the facility is deemed to be designated or reinstated.

(b) *Self-certification of rules and products.* Rules of a designated contract market and subsequent amendments thereto, including both operational rules and the terms or conditions of futures, swaps and option products listed for trading on the facility, not voluntarily submitted for prior Commission approval pursuant to paragraph (a) of this section must be submitted to the Commission with a certification that the rule, rule amendment or futures, swap or options product complies with the Act or rules thereunder pursuant to the procedures of § 40.6 of this chapter, as applicable. *Provided, however,* any rule or rule amendment that would, for a delivery month having open interest, materially change a term or condition of a swap or a contract for future delivery in an agricultural commodity enumerated in Section 1a(9) of the Act, or of an option on such contract or commodity, must be submitted to the Commission prior to its implementation for review and approval under § 40.4 of this chapter.

\* \* \* \* \*

13. Revise § 38.5 to read as follows:

**§ 38.5 Information relating to contract market compliance.**

(a) *Requests for information.* Upon request by the Commission, a designated contract market must file with the Commission such information related to its business as a designated contract market, including information relating to data entry and trade details, in the form and manner, and within the time specified by the Commission in its request.

(b) *Demonstration of compliance.* Upon request by the Commission, a designated contract market must file with the Commission a written demonstration, containing such supporting data, information and documents, in the form and manner and within such time as the Commission may specify, that the designated contract market is in compliance with one or more core principles as specified in the request, or that is requested by the Commission to satisfy its obligations under the Act.

(c) *Equity interest transfers.* (1) *Equity transfer notification.* Upon entering into any agreement(s) that could result in an equity interest transfer of ten percent or more in the contract market, the designated contract market must file a notification of the equity interest transfer with the Secretary of the Commission at its Washington, DC

headquarters at *submissions@cftc.gov* and the Division of Market Oversight at *DMOSubmissions@cftc.gov*, no later than the business day, as defined in § 40.1 of this chapter, following the date on which the designated contract market enters into a firm obligation to transfer the equity interest.

(2) *Required information.* (i) The notification must include and be accompanied by:

(A) Any relevant agreement(s), including any preliminary agreements;

(B) Any associated changes to relevant corporate documents;

(C) A chart outlining any new ownership or corporate or organizational structure;

(D) A brief description of the purpose and any impact of the equity interest transfer; and

(E) A representation from the designated contract market that it meets all of the requirements of Section 5(d) of the Act and Commission regulations adopted thereunder.

(ii) The designated contract market must keep the Commission apprised of the projected date that the transaction resulting in the equity interest transfer will be consummated, and must provide to the Commission any new agreements or modifications to the original agreement(s) filed pursuant to this section. The designated contract market must notify the Commission of the consummation of the transaction on the day in which it occurs.

(3) *Certification.* (i) Upon a transfer of an equity interest of ten percent or more in a designated contract market, the designated contract market must file with the Secretary of the Commission at its Washington, DC headquarters, at *submissions@cftc.gov*, and the Division of Market Oversight, at *DMOSubmissions@cftc.gov*, a certification that the designated contract market meets all of the requirements of Section 5(d) of the Act and Commission regulations adopted thereunder, no later than two business days, as defined in § 40.1 of this chapter, following the date on which the equity interest transfer of ten percent or more was consummated. Such certification must state whether changes to any aspects of the designated contract market’s operations were made as a result of such change in ownership, and include a description of any such change(s).

(ii) The certification required under this paragraph may rely on and be supported by reference to an application for designation or prior filings made pursuant to a product or rule submission requirement, along with any necessary new filings, including new filings that provide any and all material



updates of prior submissions. The DCM shall also amend any information that is no longer accurate on Form DCM consistent with the procedures set forth in § 38.3 of this part.

(d) *Delegation of authority.* The Commission hereby delegates, until it orders otherwise, the authority set forth in paragraph (b) of this section to the Director of the Division of Market Oversight or such other employee or employees as the Director may designate from time to time. The Director may submit to the Commission for its consideration any matter that has been delegated in this paragraph. Nothing in this paragraph prohibits the Commission, at its election, from exercising the authority delegated in this paragraph.

14. Add § 38.7 to subpart A to read as follows:

**§ 38.7 Prohibited use of data collected for regulatory purposes.**

A designated contract market may not use for business or marketing purposes any proprietary data or personal information it collects or receives, from or on behalf of any person, for the purpose of fulfilling its regulatory obligations; *provided however*, that a designated contract market, where necessary, may share such information with one or more designated contract markets, or swap execution facilities registered with the Commission, for regulatory purposes.

15. Add § 38.8 to subpart A to read as follows:

**§ 38.8 Listing of swaps on a designated contract market.**

(a) A designated contract market that lists for the first time a swap contract for trading on its contract market must, either prior to or at the time of such listing, file with the Commission a written demonstration detailing how the designated contract market is addressing its self-regulatory obligations and is fulfilling its statutory and regulatory obligations with respect to swap transactions.

(b) Prior to listing swaps for trading on or through a designated contract market, each designated contract market must request from the Commission a unique, extensible, alphanumeric code for the purpose of identifying the designated contract market pursuant to part 45 of this chapter.

16. Add § 38.9 to subpart A to read as follows:

**§ 38.9 Boards of trade operating both a designated contract market and a swap execution facility.**

(a) A board of trade that operates a designated contract market and that

intends to also operate a swap execution facility must separately register, pursuant to the swap execution facility registration requirements set forth in part 37 of this chapter, and on an ongoing basis, comply with the core principles under Section 5h of the Act, and the swap execution facility rules under part 37 of this chapter.

(b) A board of trade that operates both a designated contract market and a swap execution facility, and that uses the same electronic trade execution system for executing and trading swaps that it uses in its capacity as a designated contract market must clearly identify to market participants for each swap whether the execution or trading of such swap is taking place on the designated contract market or on the swap execution facility.

17. Add § 38.10 to subpart A to read as follows:

**§ 38.10 Reporting of swaps traded on a designated contract market.**

With respect to swaps traded on or through a designated contract market, each designated contract market must report specified swap data as provided under parts 43 and 45 of this chapter.

18. Add subparts B through X to read as follows:

**Subpart B—Designation as Contract Market**

Sec.  
38.100 Core Principle 1.

**Subpart C—Compliance With Rules**

38.150 Core Principle 2.  
38.151 Access requirements.  
38.152 Abusive trading practices prohibited.  
38.153 Capacity to detect and investigate rule violations.  
38.154 Regulatory services provided by a third party.  
38.155 Compliance staff and resources.  
38.156 Automated trade surveillance system.  
38.157 Real-time market monitoring.  
38.158 Investigations and investigation reports.  
38.159 Ability to obtain information.  
38.160 Additional rules required.

**Subpart D—Contracts Not Readily Susceptible to Manipulation**

38.200 Core Principle 3.  
38.201 Additional sources for compliance.

**Subpart E—Prevention of Market Disruption**

38.250 Core Principle 4.  
38.251 General requirements.  
38.252 Additional requirements for physical delivery markets.  
38.253 Additional requirements for cash-settled markets.  
38.254 Ability to obtain information.  
38.255 Risk controls for trading.  
38.256 Trade reconstruction.  
38.257 Regulatory service provider.  
38.258 Additional rules required.

**Subpart F—Position Limitations or Accountability**

38.300 Core Principle 5.  
38.301 Position limitations and accountability.

**Subpart G—Emergency Authority**

38.350 Core Principle 6.  
38.351 Additional sources for compliance.

**Subpart H—Availability of General Information**

38.400 Core Principle 7.  
38.401 General requirements.

**Subpart I—Daily Publication of Trading Information**

38.450 Core Principle 8.  
38.451 Reporting of trade information.

**Subpart J—Execution of Transactions**

38.500 Core Principle 9.  
38.501 General requirements.  
38.502 Minimum centralized trading requirement.  
38.503 Blocks trades on futures contracts.  
38.504 Block trades on swap contracts.  
38.505 Exchange of derivatives for related position.  
38.506 Office trades and transfer trades.

**Subpart K—Trade Information**

38.550 Core Principle 10.  
38.551 Audit trail required.  
38.552 Elements of an acceptable audit trail program.  
38.553 Enforcement of audit trail requirements.

**Subpart L—Financial Integrity of Transactions**

38.600 Core Principle 11.  
38.601 Mandatory clearing.  
38.602 General financial integrity.  
38.603 Protection of customer funds.  
38.604 Financial surveillance.  
38.605 Requirements for financial surveillance program.  
38.606 Financial regulatory services provided by a third party.  
38.607 Direct access.

**Subpart M—Protection of Markets and Market Participants**

38.650 Core Principle 12.  
38.651 Additional sources for compliance.

**Subpart N—Disciplinary Procedures**

38.700 Core Principle 13.  
38.701 Enforcement staff.  
38.702 Disciplinary panels.  
38.703 Review of investigation report.  
38.704 Notice of charges.  
38.705 Right to representation.  
38.706 Answer to charges.  
38.707 Admission or failure to deny charges.  
38.708 Denial of charges and right to hearing.  
38.709 Settlement offers.  
38.710 Hearings.  
38.711 Decisions.  
38.712 Right to appeal.  
38.713 Final decisions.  
38.714 Disciplinary sanctions.  
38.715 Summary fines for violations of rules regarding timely submission of

records, decorum, or other similar activities.

38.716 Emergency disciplinary actions.

#### Subpart O—Dispute Resolution

38.750 Core Principle 14.

38.751 Additional sources for compliance.

#### Subpart P—Governance Fitness Standards

38.800 Core Principle 15.

#### Subpart Q—Conflicts of Interest

38.850 Core Principle 16.

#### Subpart R—Composition of Governing Boards of Contract Markets

38.900 Core Principle 17.

#### Subpart S—Recordkeeping

38.950 Core Principle 18.

38.951 Additional sources for compliance.

#### Subpart T—Antitrust Considerations

38.1000 Core Principle 19.

38.1001 Additional sources for compliance.

#### Subpart U—System Safeguards

38.1050 Core Principle 20.

38.1051 General requirements.

#### Subpart V—Financial Resources

38.1100 Core Principle 21.

38.1101 General requirements.

#### Subpart W—Diversity of Boards of Directors

38.1150 Core Principle 22.

#### Subpart X—Securities and Exchange Commission

38.1200 Core Principle 23.

38.1201 Additional sources for compliance.

#### Subpart B—Designation as Contract Market

##### § 38.100 Core Principle 1.

(a) *In general.* To be designated, and maintain a designation, as a contract market, a board of trade shall comply with:

(1) Any core principle described in Section 5(d) of the Act, and

(2) Any requirement that the Commission may impose by rule or regulation pursuant to Section 8a(5) of the Act.

(b) *Reasonable discretion of the contract market.* Unless otherwise determined by the Commission by rule or regulation, a board of trade described in paragraph (a) of this section shall have reasonable discretion in establishing the manner in which the board of trade complies with the core principles described in this subsection.

#### Subpart C—Compliance With Rules

##### § 38.150 Core Principle 2.

(a) *In general.* The board of trade shall establish, monitor, and enforce compliance with the rules of the contract market, including:

(1) Access requirements;

(2) The terms and conditions of any contracts to be traded on the contract market; and

(3) Rules prohibiting abusive trade practices on the contract market.

(b) *Capacity of contract market.* The board of trade shall have the capacity to detect, investigate, and apply appropriate sanctions to any person that violates any rule of the contract market.

(c) *Requirement of rules.* The rules of the contract market shall provide the board of trade with the ability and authority to obtain any necessary information to perform any function described in this section, including the capacity to carry out such international information-sharing agreements, as the Commission may require.

##### § 38.151 Access requirements.

(a) *Jurisdiction.* Prior to granting any member or market participant access to its markets, a designated contract market must require that the member or market participant consent to its jurisdiction.

(b) *Impartial access by members, market participants and independent software vendors.* A designated contract market must provide its members, market participants and independent software vendors with impartial access to its markets and services, including:

(1) Access criteria that are impartial, transparent, and applied in a non-discriminatory manner; and

(2) Comparable fee structures for members, market participants and independent software vendors receiving equal access to, or services from, the designated contract market.

(c) *Limitations on access.* A designated contract market must establish and impartially enforce rules governing denials, suspensions, and revocations of a member's and market participant's access privileges to the designated contract market, including when such actions are part of a disciplinary or emergency action by the designated contract market.

##### § 38.152 Abusive trading practices prohibited.

A designated contract market must prohibit abusive trading practices on its markets by members and market participants. Designated contract markets that permit intermediation must prohibit customer-related abuses including, but not limited to, trading ahead of customer orders, trading against customer orders, accommodation trading, and improper cross trading. Specific trading practices that must be prohibited by all designated contract markets include front-running, wash trading, pre-

arranged trading, fraudulent trading, money passes, and any other trading practices that a designated contract market deems to be abusive. In addition, a designated contract market also must prohibit any other manipulative or disruptive trading practices prohibited by the Act or by the Commission pursuant to Commission regulation.

##### § 38.153 Capacity to detect and investigate rule violations.

A designated contract market must have arrangements and resources for effective enforcement of its rules. Such arrangements must include the authority to collect information and documents on both a routine and non-routine basis, including the authority to examine books and records kept by the designated contract market's members and by market participants. A designated contract market's arrangements and resources must also facilitate the direct supervision of the market and the analysis of data collected to determine whether a rule violation occurred.

##### § 38.154 Regulatory services provided by a third party.

(a) *Use of third-party provider permitted.* A designated contract market may choose to contract with a registered futures association or another registered entity, as such terms are defined under the CEA, (collectively, "regulatory service provider"), for the provision of services to assist in complying with the core principles, as approved by the Commission. Any designated contract market that chooses to contract with a regulatory service provider must ensure that its regulatory service provider has the capacity and resources necessary to provide timely and effective regulatory services, including adequate staff and automated surveillance systems. A designated contract market will at all times remain responsible for the performance of any regulatory services received, for compliance with the designated contract market's obligations under the CEA and Commission regulations, and for the regulatory service provider's performance on its behalf.

(b) *Duty to supervise third party.* A designated contract market that elects to utilize a regulatory service provider must retain sufficient compliance staff to supervise the quality and effectiveness of the services provided on its behalf. Compliance staff of the designated contract market must hold regular meetings with the regulatory service provider to discuss ongoing investigations, trading patterns, market participants, and any other matters of

regulatory concern. A designated contract market also must conduct periodic reviews of the adequacy and effectiveness of services provided on its behalf. Such reviews must be documented carefully and made available to the Commission upon request.

(c) *Regulatory decisions required from the designated contract market.* A designated contract market that elects to utilize a regulatory service provider must retain exclusive authority in decisions involving the cancellation of trades, the issuance of disciplinary charges against members or market participants, and denials of access to the trading platform for disciplinary reasons. A designated contract market may also retain exclusive authority in other areas of its choosing; *provided however*, that the decision to open an investigation into a possible rule violation must always reside exclusively with the regulatory service provider. A designated contract market must document any instances where its actions differ from those recommended by its regulatory service provider, including the reasons for the course of action recommended by the regulatory service provider and the reasons why the designated contract market chose a different course of action.

#### **§ 38.155 Compliance staff and resources.**

(a) *Sufficient compliance staff.* A designated contract market must establish and maintain sufficient compliance department resources and staff to ensure that it can conduct effective audit trail reviews, trade practice surveillance, market surveillance, and real-time market monitoring. The designated contract market's compliance staff must also be sufficient to address unusual market or trading events as they arise, and to conduct and complete investigations in a timely manner, as set forth in § 38.158(b) of this part.

(b) *Ongoing monitoring of compliance staff resources.* A designated contract market must monitor the size and workload of its compliance staff annually, and ensure that its compliance resources and staff are at appropriate levels. In determining the appropriate level of compliance resources and staff, the designated contract market should consider projected trading volume increases, the number of new products or contracts projected to be listed for trading, any new responsibilities expected to be assigned to compliance staff, the results of any internal review demonstrating that work is not completed in an effective or timely manner, and any

other factors suggesting the need for increased resources and staff.

#### **§ 38.156 Automated trade surveillance system.**

A designated contract market must maintain an automated trade surveillance system capable of detecting and investigating potential trade practice violations. Such system must maintain all data reflecting the details of each order entered into the trading system, including all order modifications and cancellations and maintain all data reflecting transactions executed on the designated contract market. The automated system must load and process daily orders and trades no later than 24 hours after the completion of the trading day. In addition, the automated trade surveillance system must have the capability to detect and flag specific trade execution patterns and trade anomalies; compute, retain, and compare trading statistics; compute trade gains, losses, and futures-equivalent positions; reconstruct the sequence of market activity; perform market analyses; and support system users to perform in-depth analyses and ad hoc queries of trade-related data.

#### **§ 38.157 Real-time market monitoring.**

A designated contract market must conduct real-time market monitoring of all trading activity on its electronic trading platform(s) to ensure orderly trading and identify any market or system anomalies. A designated contract market must have the authority to adjust trade prices or cancel trades when necessary to mitigate market disrupting events caused by malfunctions in its electronic trading platform(s) or errors in orders submitted by members and market participants. Any trade price adjustments or trade cancellations must be transparent to the market and subject to standards that are clear, fair, and publicly available.

#### **§ 38.158 Investigations and investigation reports.**

(a) *Procedures.* A designated contract market must establish and maintain procedures that require its compliance staff to conduct investigations of possible rule violations. An investigation must be commenced upon the receipt of a request from Commission staff or upon the discovery or receipt of information by the designated contract market that, in the judgment of its compliance staff, indicates a possible basis for finding that a violation has occurred or will occur.

(b) *Timeliness.* Each compliance staff investigation must be completed in a timely manner. Absent mitigating factors, a timely manner is no later than 12 months after the date that an investigation is opened. Mitigating factors that may reasonably justify an investigation taking longer than 12 months to complete include the complexity of the investigation, the number of firms or individuals involved as potential wrongdoers, the number of potential violations to be investigated, and the volume of documents and data to be examined and analyzed by compliance staff.

(c) *Investigation reports when a reasonable basis exists for finding a violation.* Compliance staff must submit a written investigation report for disciplinary action in every instance in which compliance staff determines from surveillance or from an investigation that a reasonable basis exists for finding a rule violation. The investigation report must include the reason the investigation was initiated; a summary of the complaint, if any; the relevant facts; compliance staff's analysis and conclusions; and a recommendation as to whether disciplinary action should be pursued. The report must also include the member or market participant's disciplinary history at the designated contract market.

(d) *Investigation reports when no reasonable basis exists for finding a violation.* If after conducting an investigation, compliance staff determines that no reasonable basis exists for finding a violation, it must prepare a written report including the reason the investigation was initiated; a summary of the complaint, if any; the relevant facts; compliance staff's analysis and conclusions; and if applicable, any recommendation that a disciplinary committee issue a warning letter in accordance with paragraph (e) of this section. If compliance staff recommends that a warning letter be issued to a member or market participant pursuant to paragraph (e) of this section, the investigation report must include a copy of the letter as well as the member or market participant's disciplinary history at the designated contract market.

(e) *Warning letters.* In addition to the action required to be taken under paragraphs (c) and (d) of this section, the rules of a designated contract market may authorize compliance staff to issue a warning letter to a person or entity under investigation or to recommend that a disciplinary committee take such an action. A warning letter issued in accordance with this section is not a penalty or an indication that a finding

of a violation has been made. A copy of a warning letter issued by compliance staff must be included in the investigation report required by paragraphs (c) and (d) of this section. No more than one warning letter for the same potential violation may be issued to the same person or entity during a rolling 12-month period.

**§ 38.159 Ability to obtain information.**

A designated contract market must have the ability and authority to obtain any necessary information to perform any function required under this subpart C of the Commission's regulations, including the capacity to carry out international information-sharing agreements as the Commission may require. Appropriate information-sharing agreements can be established with other designated contract markets and swap execution facilities, or the Commission can act in conjunction with the designated contract market to carry out such information sharing.

**§ 38.160 Additional rules required.**

A designated contract market must adopt and enforce any additional rules that it believes are necessary to comply with the requirements of this subpart C.

**Subpart D—Contracts Not Readily Subject to Manipulation**

**§ 38.200 Core Principle 3.**

The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.

**§ 38.201 Additional sources for compliance.**

Applicants and designated contract markets may refer to the guidance in appendix C of this part to demonstrate to the Commission compliance with the requirements of § 38.200 of this part.

**Subpart E—Prevention of Market Disruption**

**§ 38.250 Core Principle 4.**

The board of trade shall have the capacity and responsibility to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process through market surveillance, compliance, and enforcement practices and procedures, including:

- (a) Methods for conducting real-time monitoring of trading; and
- (b) Comprehensive and accurate trade reconstructions.

**§ 38.251 General requirements.**

A designated contract market must:

- (a) Collect and evaluate data on individual traders' market activity on an

ongoing basis in order to detect and prevent manipulation, price distortions and, where possible, disruptions of the delivery or cash-settlement process;

- (b) Monitor and evaluate general market data in order to detect and prevent manipulative activity that would result in the failure of the market price to reflect the normal forces of supply and demand;

- (c) Have the capacity to conduct real-time monitoring of trading and comprehensive and accurate trade reconstructions. The monitoring of intraday trading must include the capacity to detect abnormal price movements, unusual trading volumes, impairments to market liquidity, and position-limit violations; and

- (d) Have either manual processes or automated alerts that are effective in detecting and preventing trading abuses.

**§ 38.252 Additional requirements for physical delivery contracts.**

(a) For physical delivery contracts, the designated contract market must:

- (1) Monitor a contract's terms and conditions as to whether there is convergence between the contract price and the price of the underlying commodity;

- (2) Monitor that the deliverable supply is adequate so that the contract will not be susceptible to price manipulation or distortion;

- (3) Assess whether the deliverable commodity reasonably can be expected to be available to short traders and salable by long traders at its market value in normal cash marketing channels; and

- (4) When available, monitor data related to the size and ownership of deliverable supplies.

(b) The designated contract market must continually monitor the appropriateness of the contract's terms and conditions, including the delivery instrument, the delivery locations and location differentials, and the commodity characteristics and related differentials. The designated contract market must address conditions that are interfering with convergence or causing price distortions or market disruptions, including, when appropriate, changes to contract terms.

**§ 38.253 Additional requirements for cash-settled contracts.**

(a) For cash-settled contracts, the designated contract market must monitor:

- (1) The availability and pricing of the commodity making up the index to which the contract will be settled; and

- (2) The continued appropriateness of the methodology for deriving the index.

Designated contract markets must promptly amend any methodologies that result, or are likely to result, in manipulation, price distortions, or market disruptions, or must impose new methodologies to resolve the threat of disruptions or distortions.

(b) If a contract listed on a designated contract market is settled by reference to the price of a contract or commodity traded in another venue, including a price or index derived from prices on another designated contract market, the designated contract market must have rules that require traders on the DCM market to provide the DCM with their positions in the reference markets as the traders' contracts approach settlement. In the alternative, the DCM may have an information sharing agreement with the other venue or designated contract market.

**§ 38.254 Ability to obtain information.**

(a) The designated contract market must have rules that require traders in its contracts to keep records of their trading, including records of their activity in the underlying commodity and related derivatives markets and make such records available, upon request, to the designated contract market.

(b) A designated contract market with customers trading through intermediaries must either use a comprehensive large-trader reporting system (LTRS) or be able to demonstrate that it can obtain position data from other sources in order to conduct an effective surveillance program.

**§ 38.255 Risk controls for trading.**

The designated contract market must establish and maintain risk control mechanisms to reduce the potential risk of market disruptions, including but not limited to market restrictions that pause or halt trading in market conditions prescribed by the designated contract market. If a contract is linked to, or a substitute for, other contracts on the designated contract market or on other trading venues, such risk controls must, to the extent practicable, be coordinated with any similar controls placed on those other contracts. If a contract is based on the price of an equity security or the level of an equity index, such risk controls must, to the extent practicable, be coordinated with any similar controls placed on national security exchanges.

**§ 38.256 Trade reconstruction.**

The designated contract market must have the ability to comprehensively and accurately reconstruct all trading on its trading facility. All audit-trail data and reconstructions must be made available

to the Commission in a form, manner, and time as determined by the Commission.

**§ 38.257 Regulatory service provider.**

A designated contract market must comply with the regulations in this subpart through a dedicated regulatory department, or by delegation of that function to a registered futures association or a registered entity (collectively, “regulatory service provider”), as such terms are defined under the Act and over which the designated contract market has supervisory authority.

**§ 38.258 Additional rules required.**

A designated contract market must adopt and enforce any additional rules that it believes are necessary to comply with the requirements of subpart E of this part.

**Subpart F—Position Limitations or Accountability**

**§ 38.300 Core Principle 5.**

To reduce the potential threat of market manipulation or congestion (especially during trading in the delivery month), the board of trade shall adopt for each contract of the board of trade, as is necessary and appropriate, position limitations or position accountability for speculators. For any contract that is subject to a position limitation established by the Commission pursuant to Section 4a(a), the board of trade shall set the position limitation of the board of trade at a level not higher than the position limitation established by the Commission.

**§ 38.301 Position limitations and accountability.**

A designated contract market must meet the requirements of part 151 of this chapter.

**Subpart G—Emergency Authority**

**§ 38.350 Core Principle 6.**

The board of trade, in consultation or cooperation with the Commission, shall adopt rules to provide for the exercise of emergency authority, as is necessary and appropriate, including the authority:

- (a) To liquidate or transfer open positions in any contract;
- (b) To suspend or curtail trading in any contract; and
- (c) To require market participants in any contract to meet special margin requirements.

**§ 38.351 Additional sources for compliance.**

Applicants and designated contract markets may refer to the guidance

and/or acceptable practices in Appendix B of this part to demonstrate to the Commission compliance with the requirements of § 38.350.

**Subpart H—Availability of General Information**

**§ 38.400 Core Principle 7.**

The board of trade shall make available to market authorities, market participants, and the public accurate information concerning:

- (a) The terms and conditions of the contracts of the contract market; and
- (b)(1) The rules, regulations and mechanisms for executing transactions on or through the facilities of the contract market, and

(2) The rules and specifications describing the operation of the contract market’s:

- (i) Electronic matching platform, or
- (ii) Trade execution facility.

**§ 38.401 General requirements.**

(a) *General.* (1) A designated contract market must have procedures, arrangements and resources for disclosing to the Commission, market participants and the public accurate information pertaining to:

- (i) Contract terms and conditions;
- (ii) Rules and regulations pertaining to the trading mechanisms; and
- (iii) Rules and specifications pertaining to operation of the electronic matching platform or trade execution facility.

(2) Through such procedures, arrangements and resources, the designated contract market must ensure public dissemination of information pertaining to new product listings, new rules, rule amendments or other changes to previously disclosed information, in accordance with the timeline provided in paragraph (c) of this section.

(3) A designated contract market shall meet the requirements of this paragraph (a), by placing the information on the designated contract market’s Web site within the time prescribed in paragraph (c) of this section.

(b) *Accuracy Requirement.* A designated contract market must provide accurate and complete information and not omit material information with respect to any communication with the Commission, and any information required to be transmitted or made available to market participants and the public, including on its Web site or otherwise.

(c) *Notice of Regulatory Submissions.* (1) A designated contract market, in making available on its Web site information pertaining to new product listings, new rules, rule amendments or

other changes to previously-disclosed information, must place such information on its Web site simultaneous with the filing of such information with the Secretary of the Commission. Satisfaction of the requirements of this paragraph (c) shall be in addition to the requirements of paragraph (d) of this section.

(2) To the extent that a designated contract market requests confidential treatment of any information filed with the Secretary of the Commission, the designated contract market must post on its Web site the public version of such filing or submission.

(d) *Rulebook.* A designated contract market must ensure that the rulebook posted on its Web site is accurate, complete, current and readily accessible to the public. A designated contract market must publish or post in its rulebook all new or amended rules, both substantive and non-substantive, on the date of implementation of such new or amended rule, the day a new product is listed, or the day any changes to previously disclosed information take effect. Satisfaction of the requirements of this paragraph (d) is in addition to the requirements of paragraph (c) of this section.

**Subpart I—Daily Publication of Trading Information**

**§ 38.450 Core Principle 8.**

The board of trade shall make public daily information on settlement prices, volume, open interest, and opening and closing ranges for actively traded contracts on the contract market.

**§ 38.451 Reporting of trade information.**

A designated contract market must meet the reporting requirements set forth in part 16 of this chapter.

**Subpart J—Execution of Transactions**

**§ 38.500 Core Principle 9.**

The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market of the board of trade. The rules of the board of trade may authorize, for bona fide business purposes:

- (a) Transfer trades or office trades;
- (b) An exchange of:
  - (1) Futures in connection with a cash commodity transaction;
  - (2) Futures for cash commodities; or
  - (3) Futures for swaps; or
- (c) A futures commission merchant, acting as principal or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity

for future delivery if the contract is reported, recorded, or cleared in accordance with the rules of the contract market or a derivatives clearing organization.

**§ 38.501 General requirements.**

(a) *Transactions on the centralized market; requirements.* All purchases and sales of any commodity for future delivery, and any commodity option or swap, on or subject to the rules of a designated contract market, must be executed openly and competitively by open outcry, posting of bids and offers, or other equally open and competitive methods, in a place or through an electronic system provided by the designated contract market, during the hours prescribed by the designated contract market for trading in such commodity, commodity option or swap.

(b) *Transactions off the centralized market; requirements.* Notwithstanding paragraph (a) of this section, transactions may be executed off of a designated contract market's centralized market, including transfer trades, office trades, block trades, or trades involving the exchange of derivatives for related positions, if transacted in accordance with the written rules of the designated contract market that provide for execution of transactions off the centralized market and that have been certified to or approved by the Commission. Every person handling, executing, clearing, or carrying the trades, transactions or positions described in this paragraph shall comply with the rules of the appropriate designated contract market, including to identify and mark by appropriate symbol or designation all such transactions or contracts and all orders, records and memoranda pertaining thereto.

**§ 38.502 Minimum centralized market trading requirement.**

(a) *Minimum centralized market trading percentage requirement.* No designated contract market may continue to list a contract for trading unless an average of 85% or greater of the total volume of such contract is traded on the designated contract market's centralized market, as calculated over a 12 month period as specified in paragraph (b) of this section.

(b) *Centralized market trading percentage calculation.* (1) *Contracts listed after the effective date of this section.* For each new contract listed after the effective date of § 38.502, the designated contract market must determine the percentage of the total volume, in all contract months

combined, that is attributable to centralized market trading for a 12 month period commencing one year following the date of the contract's initial listing on the designated contract market, and on each 12 month anniversary of the contract's listing thereafter. The designated contract market must calculate the centralized market trading percentage for each listed contract within thirty days following the conclusion of the 12 month anniversary of each contract's listing.

(2) *Contracts listed as of the effective date of this section.* For contracts and contract months listed as of the effective date of § 38.502, the designated contract market initially must complete the centralized market trading percentage calculation in each such contract within thirty days of the effective date of this § 38.502 ("Initial Calculation").

(3) *Initial Calculation.* The Initial Calculation for each such existing contract must be based on:

(i) The trading volume in such contract during the 12 month period immediately preceding the effective date of this section; or

(ii) If contract has been listed less than 12 months, the trading volume in such contract during the time period in which the contract was initially listed on the designated contract market.

(4) *Anniversary Calculation.* Thereafter, the designated contract market must calculate and file with the Commission the centralized market trading percentage in each such contract within thirty days of the 12 month anniversary of the Initial Calculation.

(c) *Mandatory delisting.* Except as otherwise provided in paragraph (d) of this section, as to any contract that does not meet the minimum centralized market trading percentage requirement of paragraph (a) of this section, within ninety days of the centralized market trading percentage calculation, the designated contract market must:

(1) Delist the contract from the designated contract market and transfer open positions in the contract to a SEF that it operates;

(2) Delist the contract from the designated contract market and transfer all open positions in the contract to another SEF that will accept the contract; or

(3) Liquidate the contract.

(d) *Treatment of contracts listed as of the effective date of this section.* Contracts and contract months that are listed on a designated contract market as of the effective date of § 38.502 and that do not meet the requirements of paragraph (a) of this section, as calculated in accordance with paragraph

(b) of this section, may continue to be listed on the designated contract market until all open positions in such contracts and contract months are liquidated. Trading in such contracts is allowed for liquidation purposes only.

(e) *Exemptions upon petition.* (1) A designated contract market may petition the Commission to exempt a contract from the requirements of paragraphs (c) or (d) of this section, for a maximum period of 12 months, or such other time as determined by the Commission.

(2) The designated contract market must demonstrate in its petition that:

(i) (A) Such contract achieved an average of at least 50% trading volume on the centralized market over the preceding 12 month period, and

(B) The contract is likely to attain the minimum centralized market trading percentage requirement within the following 12 month period; or

(ii) As of the effective date of this section, such contract has been listed for less than 12 months.

(3) Petitions seeking an exemption from the mandatory delisting requirement must be submitted to the Commission within thirty-five days of the 12 month anniversary of the listing of such contract, or for contracts listed less than 12 months, thirty-five days after the effective date of this section, as applicable.

(4) The filing of a petition for a mandatory delisting exemption shall toll the mandatory delisting requirement set forth in paragraph (c) of this section until such time that a decision is made on the petition.

**§ 38.503 Block trades on futures contracts.**

(a) *Block trade rules.* A designated contract market that permits block trade transactions on futures contracts must have rules that limit such block trades to large transactions, and impose minimum size requirements on such transactions that are appropriate for each listed contract subject to a block trading provision. The block trade size for each listed contract must be certified to or approved by the Commission.

(b) *Block size review.* A designated contract market must review the minimum size thresholds for all block trades on futures contracts on an annual basis to ensure that the minimum size remains appropriate for each contract, and in accordance with the provisions of this section 38.503.

(c) *Eligible block trade participants.* Block trading must be limited to Eligible Contract Participants, as that term is defined in Section 1a(18) of the Act, except that the designated contract market may allow a commodity trading advisor acting in an asset managerial

capacity and registered pursuant to Section 4n of the Act, or a principal thereof, including any investment advisor who satisfies the criteria of § 4.7(a)(2)(v) of this chapter, or a foreign person performing a similar role or function and subject as such to foreign regulation, to transact block trades for customers who are not Eligible Contract Participants, if such commodity trading advisor, investment advisor or foreign person has more than \$25,000,000 in total assets under management. A person may transact a block trade on behalf of a customer only when such person has received an instruction or prior consent to do so from the customer.

(d) *Affiliated parties.* (1) Block trades between affiliated parties are permitted under the circumstances provided in paragraph (d)(3) of this section.

(2) For purposes of block trades, an affiliated party is a party that directly or indirectly through one or more persons, controls, is controlled by, or is under common control with another party.

(3) Block trades between affiliated parties are permitted if:

(i) Priced on a competitive market price, either by falling within the contemporaneous bid-ask spread on the centralized market or calculated based on a contemporaneous market price in a related cash market;

(ii) Each party has a separate and independent legal bona fide business purpose for engaging in the trades; and

(iii) Each party's decision to enter into the block trade is made by a separate and independent decision-maker.

(e) *Aggregation.* Except as otherwise stated in this paragraph (e), the aggregation of orders for different accounts in order to satisfy the minimum block size requirement is prohibited. Aggregation is permissible if done by a commodity trading advisor acting in an asset managerial capacity and registered pursuant to Section 4n of the Act, or a principal thereof, including any investment advisor who satisfies the criteria of § 4.7(a)(2)(v) of this chapter, or a foreign person performing a similar role or function and subject as such to foreign regulation, if such commodity trading advisor, investment advisor or foreign person has more than \$25,000,000 in total assets under management.

(f) *Recordkeeping.* Parties to, and members facilitating, a block trade must keep accurate block trade records that comply with Sections 5(d)(10) and 5(d)(18) of the Act and the associated Commission regulations in subparts K and S of this part. Block trade orders must be recorded by the member and time-stamped with both the time the

order was received and the time the order was reported to the designated contract market, and must indicate if the block trades are between affiliated parties. When requested by the designated contract market, the Commission or the Department of Justice, parties to, and members facilitating, a block trade must provide records to document that the block trade is executed in conformance with the board of trade's rules.

(g) *Reporting.* (1) Each block trade must be reported to the designated contract market within five minutes after its execution.

(2) The designated contract market must publicize the details of each block trade immediately upon receipt of the transaction report, and must publicize daily the total quantity of block trades that are included in the total volume of trading under the procedures set forth in § 16.01 of this chapter.

(h) *Block size determinations; pricing of block trades.* Applicants and designated contract markets may refer to the guidance and acceptable practices in appendix B of this part to demonstrate to the Commission compliance with the requirements for block size determinations and pricing of block trades.

#### **§ 38.504 Block trades on swap contracts.**

A designated contract market must have rules requiring that block trades involving swaps comply with the requirements set forth in part 43 of this chapter.

#### **§ 38.505 Exchange of derivatives for related position.**

(a) (1) A designated contract market may permit bona fide exchange of derivatives for related positions transactions.

(2) (i) A bona fide exchange of derivatives for related positions transaction must include:

(A) Separate but integrally related transactions involving the same or a related commodity;

(B) Price correlation and quantitative equivalence of the derivative and related position legs; and

(C) A buyer of a derivative who is the seller of the corresponding related position, and a seller of a derivative who is the buyer of the corresponding related position.

(ii) The transaction must result in an actual transfer of ownership of the related position and occur between parties with different beneficial owners or under separate control.

(iii) The price differential between the futures leg and the commodities leg or derivatives position should reflect

commercial realities, and at least one leg of the transaction should be priced at the prevailing market price.

(b) A designated contract market may permit parties to an exchange of derivatives for related position transaction to engage in a separate transaction that offsets a leg of the exchange of derivatives for a related position if:

(1) The offsetting transaction results in an actual transfer of ownership and demonstrates other indicia of being a bona fide transaction as set forth in paragraph (a) of this section; and

(2) The offsetting transaction must be able to stand on its own as a commercially appropriate transaction, with no obligation on either party that the offsetting transaction be dependent upon the execution of the exchange of derivatives for related position transaction, or that the exchange of derivatives for a related position transaction be dependent upon the execution of the offsetting transaction.

(c) An exchange of derivatives for a related position transaction must be bona fide such that the exchange of derivatives for the related position is not contingent upon an offsetting transaction.

(d) An exchange of derivatives for a related position transaction must be reported to the designated contract market within five minutes after its execution.

(e) A designated contract market must make public, on a daily basis, the total quantity of exchanges of derivatives for a related position transactions that are included in the total volume of trading under the procedures set forth in § 16.01 of this chapter.

#### **§ 38.506 Office trades and transfer trades.**

A designated contract market must keep records of office trades and transfer trades under the procedures set forth in § 1.31 of this chapter.

### **Subpart K—Trade Information**

#### **§ 38.550 Core Principle 10.**

The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information:

(a) To assist in the prevention of customer and market abuses; and

(b) To provide evidence of any violations of the rules of the contract market.

#### **§ 38.551 Audit trail required.**

A designated contract market must capture and retain all audit trail data

necessary to detect, investigate, and prevent customer and market abuses. Such data must be sufficient to reconstruct all transactions within a reasonable period of time and to provide evidence of any violations of the rules of the designated contract market. An acceptable audit trail must also permit the designated contract market to track a customer order from the time of receipt through fill, allocation, or other disposition, and must include both order and trade data.

**§ 38.552 Elements of an acceptable audit trail program.**

(a) *Original source documents.* A designated contract market's audit trail must include original source documents. Original source documents include unalterable, sequentially identified records on which trade execution information is originally recorded, whether recorded manually or electronically. Records for customer orders (whether filled, unfilled or cancelled, each of which shall be retained or electronically captured) must reflect the terms of the order, an account identifier that relates back to the account(s) owner(s), and the time of order entry. For open-outcry trades, the time of report of execution of the order shall also be captured.

(b) *Transaction history database.* A designated contract market's audit trail program must include an electronic transaction history database. An adequate transaction history database includes a history of all orders and trades, and also includes:

(1) All data that are input into the trade entry or matching system for the transaction to match and clear;

(2) The categories of participants for which such trades are executed, including whether the person executing a trade was executing it for his/her own account or an account for which he/she has discretion, his/her clearing member's house account, the account of another member, including market participants present on the floor, or the account of any other customer;

(3) Timing and sequencing data adequate to reconstruct trading; and

(4) Identification of each account to which fills are allocated.

(c) *Electronic analysis capability.* A designated contract market's audit trail program must include electronic analysis capability with respect to all audit trail data in the transaction history database. An adequate electronic analysis capability must permit the sorting and presentation of data in the transaction history database so as to reconstruct trading and identify possible

trading violations with respect to both customer and market abuse.

(d) *Safe storage capability.* A designated contract market's audit trail program must include the capability to safely store all audit trail data retained in its transaction history database. Such safe storage capability must include the capability to store all data in the database in a manner that protects it from unauthorized alteration, as well as from accidental erasure or other loss. Data must be retained in accordance with the recordkeeping requirements of Core Principle 18 and the associated regulations in subpart S of this part.

**§ 38.553 Enforcement of audit trail requirements.**

(a) *Annual audit trail and recordkeeping reviews.* A designated contract market must enforce its audit trail and recordkeeping requirements through at least annual reviews of all members and market participants to verify their compliance with the contract market's audit trail and recordkeeping requirements. Such reviews must include, but are not limited to, the following:

(1) For electronic trading, audit trail and recordkeeping reviews must include reviews of randomly selected samples of front-end audit trail data for order routing systems; a review of the process by which user identifications are assigned and user identification records are maintained; a review of usage patterns associated with user identifications to monitor for violations of user identification rules; and reviews of account numbers and customer type indicator codes in trade records to test for accuracy and improper use.

(2) For open outcry trading, audit trail and recordkeeping reviews must include reviews of members' and market participants' compliance with the designated contract market's trade timing, order ticket, and trading card requirements.

(b) *Enforcement program required.* A designated contract market must establish a program for effective enforcement of its audit trail and recordkeeping requirements for both electronic and open-outcry trading, as applicable. An effective program must identify members and market participants that have failed to maintain high levels of compliance with such requirements, and levy meaningful sanctions when deficiencies are found. Sanctions must be sufficient to deter recidivist behavior, and may not include more than one warning letter for the same violation within a rolling twelve month period.

**Subpart L—Financial Integrity of Transactions**

**§ 38.600 Core Principle 11.**

The board of trade shall establish and enforce:

(a) Rules and procedures for ensuring the financial integrity of transactions entered into on or through the facilities of the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization); and

(b) Rules to ensure:

(1) The financial integrity of any:

(i) Futures commission merchant, and

(ii) Introducing broker; and

(2) The protection of customer funds.

**§ 38.601 Mandatory clearing.**

Transactions executed on or through the designated contract market, other than transactions in security futures products, must be cleared through a Commission-registered derivatives clearing organization, in accordance with the provisions of part 39 of this chapter.

**§ 38.602 General financial integrity.**

A designated contract market must provide for the financial integrity of its transactions by establishing and maintaining appropriate minimum financial standards for its members and non-intermediated market participants.

**§ 38.603 Protection of customer funds.**

A designated contract market must have rules concerning the protection of customer funds. These rules shall address appropriate minimum financial standards for intermediaries, the segregation of customer and proprietary funds, the custody of customer funds, the investment standards for customer funds, intermediary default procedures and related recordkeeping. A designated contract market must review the default rules and procedures of the derivatives clearing organization that clears for such designated contract market to wind down operations, transfer customers, or otherwise protect customers in the event of a default of a clearing member or the derivatives clearing organization.

**§ 38.604 Financial surveillance.**

A designated contract market must monitor members' compliance with the designated contract market's minimum financial standards and, therefore, must routinely receive and promptly review financial and related information from its members, as well as continuously monitor the positions of members and their customers. A designated contract market must have rules that prescribe minimum capital requirements for member futures commission merchants



and introducing brokers. A designated contract market must:

(a) Continually survey the obligations of each futures commission merchant created by the positions of its customers;

(b) As appropriate, compare those obligations to the financial resources of the futures commission merchant; and

(c) Take appropriate steps to use this information to protect customer funds.

**§ 38.605 Requirements for financial surveillance program.**

A designated contract market's financial surveillance program for futures commission merchants, retail foreign exchange dealers, and introducing brokers must comply with the requirements of § 1.52 of this chapter to assess the compliance of such entities with applicable contract market rules and Commission regulations.

**§ 38.606 Financial regulatory services provided by a third party.**

A designated contract market may comply with the requirements of § 38.604 (Financial Surveillance) and § 38.605 (Requirements for Financial Surveillance Program) of this part through the regulatory services of a registered futures association or a registered entity (collectively, "regulatory service provider"), as such terms are defined under the Act. A designated contract market must ensure that its regulatory service provider has the capacity and resources necessary to provide timely and effective regulatory services, including adequate staff and appropriate surveillance systems. A designated contract market will at all times remain responsible for compliance with its obligations under the Act and Commission regulations, and for the regulatory service provider's performance on its behalf. Regulatory services must be provided under a written agreement with a regulatory services provider that shall specifically document the services to be performed as well as the capacity and resources of the regulatory service provider with respect to the services to be performed.

**§ 38.607 Direct access.**

A designated contract market that permits direct electronic access by customers (i.e., allowing customers of futures commission merchants to enter orders directly into a designated contract market's trade matching system for execution) must have in place effective systems and controls reasonably designed to enable the FCM's management of financial risk, such as automated pre-trade controls that enable member futures commission

merchants to implement appropriate financial risk limits. A designated contract market must implement and enforce rules requiring the member futures commission merchants to use the provided systems and controls.

**Subpart M—Protection of Markets and Market Participants**

**§ 38.650 Core Principle 12.**

The board of trade shall establish and enforce rules:

(a) To protect markets and market participants from abusive practices committed by any party, including abusive practices committed by a party acting as an agent for a participant; and

(b) To promote fair and equitable trading on the contract market.

**§ 38.651 Additional sources for compliance.**

A designated contract market must have and enforce rules that are designed to promote fair and equitable trading and to protect the market and market participants from abusive practices including fraudulent, noncompetitive or unfair actions, committed by any party. The designated contract market must have methods and resources appropriate to the nature of the trading system and the structure of the market to detect trade practice and market abuses and to discipline such behavior, in accordance with Core Principles 2 and 4, and the associated regulations in subparts C and E of this part, respectively. The designated contract market also must provide a competitive, open and efficient market and mechanism for executing transactions in accordance with Core Principle 9 and the associated regulations under subpart J of this part.

**Subpart N—Disciplinary Procedures**

**§ 38.700 Core Principle 13.**

The board of trade shall establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market participants that violate the rules of the board of trade, or similar methods for performing the same functions, including delegation of the functions to third parties.

**§ 38.701 Enforcement staff.**

A designated contract market must establish and maintain sufficient enforcement staff and resources to effectively and promptly prosecute possible rule violations within the disciplinary jurisdiction of the contract market. A designated contract market must also monitor the size and workload of its enforcement staff annually, and ensure that its

enforcement resources and staff are at appropriate levels. The enforcement staff may not include either members of the designated contract market or persons whose interests conflict with their enforcement duties. A member of the enforcement staff may not operate under the direction or control of any person or persons with trading privileges at the contract market. A designated contract market's enforcement staff may operate as part of the designated contract market's compliance department.

**§ 38.702 Disciplinary panels.**

(a) *Disciplinary panels required.* A designated contract market must establish one or more Review Panels and one or more Hearing Panels (collectively, "disciplinary panels") that are authorized to fulfill their obligations under the rules of this subpart.

Disciplinary panels must meet the composition requirements of § 40.9(c)(3)(ii) of this chapter, and must not include any members of the designated contract market's compliance staff, or any person involved in adjudicating any other stage of the same proceeding.

(b) *Review panels.* A designated contract market's Review Panel(s) must be responsible for determining whether a reasonable basis exists for finding a violation of contract market rules, and for authorizing the issuance of notices of charges against persons alleged to have committed violations if the Review Panel believes that the matter should be adjudicated.

(c) *Hearing Panels.* A designated contract market's Hearing Panel(s) must be responsible for adjudicating disciplinary cases pursuant to a notice of charges authorized by a Review Panel, and must also be responsible for such other duties as are specified in this subpart.

**§ 38.703 Review of investigation report.**

Promptly after receiving a completed investigation report pursuant to § 38.158(c) of this part, a Review Panel must promptly review the report and, within 30 days of such receipt, must take one of the following actions:

(a) If the Review Panel determines that additional investigation or evidence is needed, it must promptly direct the compliance staff to conduct further investigation.

(b) If the Review Panel determines that no reasonable basis exists for finding a violation or that prosecution is otherwise unwarranted, it may direct that no further action be taken. Such determination must be in writing, and must include a written statement setting

forth the facts and analysis supporting the decision.

(c) If the Review Panel determines that a reasonable basis exists for finding a violation and adjudication is warranted, it must direct that the person or entity alleged to have committed the violation be served with a notice of charges and must proceed in accordance with the rules of this section.

#### **§ 38.704 Notice of charges.**

A notice of charges must adequately state the acts, conduct, or practices in which the respondent is alleged to have engaged; state the rule, or rules, alleged to have been violated (or about to be violated); and prescribe the period within which a hearing on the charges may be requested. The notice must also advise the respondent charged that he is entitled, upon request, to a hearing on the charges; and if the rules of the designated contract market so provide:

(a) That failure to request a hearing within the period prescribed in the notice, except for good cause, may be deemed a waiver of the right to a hearing; and

(b) That failure to answer or to deny expressly a charge may be deemed to be an admission of such charge.

#### **§ 38.705 Right to representation.**

Upon being served with a notice of charges, a respondent must have the right to be represented by legal counsel or any other representative of its choosing in all succeeding stages of the disciplinary process.

#### **§ 38.706 Answer to charges.**

A respondent must be given a reasonable period of time to file an answer to a notice of charges. The rules of a designated contract market may require that:

(a) The answer must be in writing and include a statement that the respondent admits, denies, or does not have and is unable to obtain sufficient information to admit or deny each allegation. A statement of a lack of sufficient information shall have the effect of a denial of an allegation;

(b) Failure to file an answer on a timely basis shall be deemed an admission of all allegations contained in the notice of charges; and

(c) Failure in an answer to deny expressly a charge shall be deemed to be an admission of such charge.

#### **§ 38.707 Admission or failure to deny charges.**

The rules of a designated contract market may provide that if a respondent admits or fails to deny any of the charges a Hearing Panel may find that the violations alleged in the notice of

charges for which the respondent admitted or failed to deny any of the charges have been committed. If the designated contract market's rules so provide, then:

(a) The Hearing Panel must impose a sanction for each violation found to have been committed;

(b) The Hearing Panel must promptly notify the respondent in writing of any sanction to be imposed pursuant to paragraph (a) of this section and shall advise the respondent that it may request a hearing on such sanction within the period of time, which shall be stated in the notice;

(c) The rules of a designated contract market may provide that if a respondent fails to request a hearing within the period of time stated in the notice, the respondent will be deemed to have accepted the sanction.

#### **§ 38.708 Denial of charges and right to hearing.**

In every instance where a respondent has requested a hearing on a charge that is denied, or on a sanction set by the Hearing Panel pursuant to § 38.707 of this part, the respondent must be given an opportunity for a hearing in accordance with the requirements of § 38.710 of this part. The designated contract market's rules may provide that, except for good cause, the hearing must be concerned only with those charges denied and/or sanctions set by the Hearing Panel under § 38.707 of this part for which a hearing has been requested.

#### **§ 38.709 Settlement offers.**

(a) The rules of a designated contract market may permit a respondent to submit a written offer of settlement at any time after the investigation report is completed. The disciplinary panel presiding over the matter may accept the offer of settlement, but may not alter the terms of a settlement offer unless the respondent agrees.

(b) The rules of a designated contract market may provide that, in its discretion, a disciplinary panel may permit the respondent to accept a sanction without either admitting or denying the rule violations upon which the sanction is based.

(c) If an offer of settlement is accepted, the panel accepting the offer must issue a written decision specifying the rule violations it has reason to believe were committed, including the basis or reasons for the panel's conclusions, and any sanction to be imposed, which must include full customer restitution where customer harm is demonstrated. If an offer of settlement is accepted without the

agreement of the enforcement staff, the decision must adequately support the Hearing Panel's acceptance of the settlement. Where applicable, the decision must also include a statement that the respondent has accepted the sanctions imposed without either admitting or denying the rule violations.

(d) The respondent may withdraw his or her offer of settlement at any time before final acceptance by a panel. If an offer is withdrawn after submission, or is rejected by a disciplinary panel, the respondent must not be deemed to have made any admissions by reason of the offer of settlement and must not be otherwise prejudiced by having submitted the offer of settlement.

#### **§ 38.710 Hearings.**

(a) A designated contract market must adopt rules that provide for the following minimum requirements for any hearing conducted pursuant to a notice of charges:

(1) The hearing must be fair, must be conducted before members of the Hearing Panel, and must be promptly convened after reasonable notice to the respondent. The formal rules of evidence need not apply; nevertheless, the procedures for the hearing may not be so informal as to deny a fair hearing. No member of the Hearing Panel for the matter may have a financial, personal, or other direct interest in the matter under consideration.

(2) In advance of the hearing, the respondent must be entitled to examine all books, documents, or other evidence in the possession or under the control of the designated contract market that are to be relied upon by the enforcement staff in presenting the charges contained in the notice of charges or which are relevant to those charges.

(3) The designated contract market's enforcement and compliance staffs must be parties to the hearing, and the enforcement staff must present their case on those charges and sanctions that are the subject of the hearing.

(4) The respondent must be entitled to appear personally at the hearing, must be entitled to cross-examine any persons appearing as witnesses at the hearing, and must be entitled to call witnesses and to present such evidence as may be relevant to the charges.

(5) The designated contract market must require persons within its jurisdiction who are called as witnesses to participate in the hearing and to produce evidence. It must make reasonable efforts to secure the presence of all other persons called as witnesses whose testimony would be relevant.

(6) If the respondent has requested a hearing, a copy of the hearing must be

made and must become a part of the record of the proceeding. The record must be one that is capable of being accurately transcribed; however, it need not be transcribed unless the transcript is requested by Commission staff or the respondent, the decision is appealed pursuant to § 38.712 of this part, or is reviewed by the Commission pursuant to Section 8c of the Act or part 9 of this chapter. In all other instances a summary record of a hearing is permitted.

(7) The rules of a designated contract market may provide that the cost of transcribing the record of the hearing must be borne by a respondent who requests the transcript, appeals the decision pursuant to § 38.712 of this part, or whose application for Commission review of the disciplinary action has been granted. In all other instances, the cost of transcribing the record must be borne by the designated contract market.

(b) The rules of a designated contract market may provide that a sanction may be summarily imposed upon any person within its jurisdiction whose actions impede the progress of a hearing.

#### **§ 38.711 Decisions.**

Promptly following a hearing conducted in accordance with § 38.710 of this part, the Hearing Panel must render a written decision based upon the weight of the evidence contained in the record of the proceeding and must provide a copy to the respondent.

The decision must include:

- (a) The notice of charges or a summary of the charges;
- (b) The answer, if any, or a summary of the answer;
- (c) A summary of the evidence produced at the hearing or, where appropriate, incorporation by reference of the investigation report;
- (d) A statement of findings and conclusions with respect to each charge, and a complete explanation of the evidentiary and other basis for such findings and conclusions with respect to each charge;
- (e) An indication of each specific rule that the respondent was found to have violated; and
- (f) A declaration of all sanctions imposed against the respondent, including the basis for such sanctions and the effective date of such sanctions.

#### **§ 38.712 Right to appeal.**

The rules of a designated contract market may permit the parties to a proceeding to appeal promptly an adverse decision of the Hearing Panel in all or in certain classes of cases. Such rules may require a party's notice of

appeal to be in writing and to specify the findings, conclusions, or sanctions to which objection are taken. If the rules of a designated contract market permit appeals, then both the respondent and the enforcement staff must have the opportunity to appeal and the designated contract must provide for the following:

(a) The designated contract market must establish an appellate panel that must be authorized to hear appeals of respondents. In addition, the rules of a designated contract market may provide that the appellate panel may, on its own initiative, order review of a decision by the Hearing Panel within a reasonable period of time after the decision has been rendered.

(b) The composition of the appellate panel must be consistent with § 40.9(c)(iv) of this chapter, and must not include any members of the designated contract market's compliance staff, or any person involved in adjudicating any other stage of the same proceeding. The rules of a designated contract market must provide for the appeal proceeding to be conducted before all of the members of the board of appeals or a panel thereof.

(c) Except for good cause shown, the appeal or review must be conducted solely on the record before the Hearing Panel, the written exceptions filed by the parties, and the oral or written arguments of the parties.

(d) Promptly following the appeal or review proceeding, the board of appeals must issue a written decision and must provide a copy to the respondent. The decision issued by the board of appeal must adhere to all the requirements of § 38.711 of this part, to the extent that a different conclusion is reached from that issued by the Hearing Panel.

#### **§ 38.713 Final decisions.**

Each designated contract market must establish rules setting forth when a decision rendered pursuant to this section will become the final decision of such designated contract market.

#### **§ 38.714 Disciplinary sanctions.**

All disciplinary sanctions imposed by a designated contract market or its disciplinary panels must be commensurate with the violations committed and must be clearly sufficient to deter recidivism or similar violations by other market participants. All disciplinary sanctions must take into account the respondent's disciplinary history. In the event of demonstrated customer harm, any disciplinary sanction must also include full customer restitution.

#### **§ 38.715 Summary fines for violations of rules regarding timely submission of records, decorum, or other similar activities.**

A designated contract market may adopt a summary fine schedule for violations of rules relating to the timely submission of accurate records required for clearing or verifying each day's transactions, decorum, attire, or other similar activities. A designated contract market may permit its compliance staff, or a designated panel of contract market officials, to summarily impose minor sanctions against persons within the designated contract market's jurisdiction for violating such rules. A designated contract market's summary fine schedule may allow for warning letters to be issued for first-time violations or violators, provided that no more than one warning letter may be issued per rolling 12-month period for the same violation. If adopted, a summary fine schedule must provide for progressively larger fines for recurring violations.

#### **§ 38.716 Emergency disciplinary actions.**

(a) A designated contract market may impose a sanction, including suspension, or take other summary action against a person or entity subject to its jurisdiction upon a reasonable belief that such immediate action is necessary to protect the best interest of the marketplace.

(b) Any emergency disciplinary action must be taken in accordance with a designated contract market's procedures that provide for the following:

(1) If practicable, a respondent must be served with a notice before the action is taken, or otherwise at the earliest possible opportunity. The notice must state the action, briefly state the reasons for the action, and state the effective time and date, and the duration of the action.

(2) The respondent must have the right to be represented by legal counsel or any other representative of its choosing in all proceedings subsequent to the emergency action taken. The respondent must be given the opportunity for a hearing as soon as reasonably practicable and the hearing must be conducted before the Hearing Panel pursuant to the requirements of § 38.710 of this part.

(3) Promptly following the hearing provided for in this rule, the designated contract market must render a written decision based upon the weight of the evidence contained in the record of the proceeding and must provide a copy to the respondent. The decision must include a description of the summary action taken; the reasons for the

summary action; a summary of the evidence produced at the hearing; a statement of findings and conclusions; a determination that the summary action should be affirmed, modified, or reversed; and a declaration of any action to be taken pursuant to the determination, and the effective date and duration of such action.

### Subpart O—Dispute Resolution

#### § 38.750 Core Principle 14.

The board of trade shall establish and enforce rules regarding, and provide facilities for alternative dispute resolution as appropriate for, market participants and any market intermediaries.

#### § 38.751 Additional sources for compliance.

Applicants and designated contract markets may refer to the guidance and acceptable practices in Appendix B of this part to demonstrate to the Commission compliance with the requirements of § 38.750 of this part.

### Subpart P—Governance Fitness Standards

#### § 38.800 Core Principle 15.

The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other person with direct access to the facility (including any party affiliated with any person described in this paragraph).

### Subpart Q—Conflicts of Interest

#### § 38.850 Core Principle 16.

The board of trade shall establish and enforce rules:

- (a) To minimize conflicts of interest in the decision-making process of the contract market; and
- (b) To establish a process for resolving conflicts of interest described in paragraph (a) of this section.

### Subpart R—Composition of Governing Boards of Contract Markets

#### § 38.900 Core Principle 17.

The governance arrangements of the board of trade shall be designed to permit consideration of the views of market participants.

### Subpart S—Recordkeeping

#### § 38.950 Core Principle 18.

The board of trade shall maintain records of all activities relating to the business of the contract market:

- (a) In a form and manner that is acceptable to the Commission; and

- (b) For a period of at least 5 years.

#### § 38.951 Additional sources for compliance.

A designated contract market must maintain such records, including trade records and investigatory and disciplinary files, in accordance with the requirements of § 1.31 of this chapter, and in accordance with § 45.1 of this chapter, if applicable.

### Subpart T—Antitrust Considerations

#### § 38.1000 Core Principle 19.

Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall not:

- (a) Adopt any rule or taking any action that results in any unreasonable restraint of trade; or
- (b) Impose any material anticompetitive burden on trading on the contract market.

#### § 38.1001 Additional sources for compliance.

Applicants and designated contract markets may refer to the guidance and acceptable practices in appendix B of this part to demonstrate to the Commission compliance with the requirements of § 38.1000 of this part.

### Subpart U—System Safeguards

#### § 38.1050 Core Principle 20.

Each designated contract market shall:

- (a) Establish and maintain a program of risk analysis and oversight to identify and minimize sources of operational risk, through the development of appropriate controls and procedures, and the development of automated systems, that are reliable, secure, and have adequate scalable capacity;
- (b) Establish and maintain emergency procedures, backup facilities, and a plan for disaster recovery that allow for the timely recovery and resumption of operations and the fulfillment of the responsibilities and obligations of the board of trade; and

(c) Periodically conduct tests to verify that backup resources are sufficient to ensure continued order processing and trade matching, transmission of matched orders to a designated clearing organization for clearing, price reporting, market surveillance, and maintenance of a comprehensive and accurate audit trail.

#### § 38.1051 General requirements.

(a) A designated contract market's program of risk analysis and oversight with respect to its operations and automated systems must address each of the following categories of risk analysis and oversight:

- (1) Information security;
- (2) Business continuity-disaster recovery planning and resources;
- (3) Capacity and performance planning;
- (4) Systems operations;
- (5) Systems development and quality assurance; and
- (6) Physical security and environmental controls.

(b) In addressing the categories of risk analysis and oversight required under paragraph (a) of this section, a designated contract market should follow generally accepted standards and best practices with respect to the development, operation, reliability, security, and capacity of automated systems.

(c) A designated contract market must maintain a business continuity-disaster recovery plan and business continuity-disaster recovery resources, emergency procedures, and backup facilities sufficient to enable timely recovery and resumption of its operations and resumption of its ongoing fulfillment of its responsibilities and obligations as a designated contract market following any disruption of its operations. Such responsibilities and obligations include, without limitation, order processing and trade matching; transmission of matched orders to a designated clearing organization for clearing; price reporting; market surveillance; and maintenance of a comprehensive audit trail. The designated contract market's business continuity-disaster recovery plan and resources generally should enable resumption of trading and clearing of the designated contract market's products during the next business day following the disruption. Designated contract markets determined by the Commission to be critical financial markets are subject to more stringent requirements in this regard, set forth in § 40.9 of this chapter. Electronic trading is an acceptable backup for open outcry trading in the event of a disruption.

(d) A designated contract market that is not determined by the Commission to be a critical financial market satisfies the requirement to be able to resume trading and clearing during the next business day following a disruption by maintaining either:

- (1) Infrastructure and personnel resources of its own that are sufficient to ensure timely recovery and resumption of its operations and resumption of its ongoing fulfillment of its responsibilities and obligations as a designated contract market following any disruption of its operations; or
- (2) Contractual arrangements with other designated contract markets or

disaster recovery service providers, as appropriate, that are sufficient to ensure continued trading and clearing of the designated contract market's products, and ongoing fulfillment of all of the designated contract market's responsibilities and obligations with respect to those products, in the event that a disruption renders the designated contract market temporarily or permanently unable to satisfy this requirement on its own behalf.

(e) A designated contract market must notify Commission staff promptly of all:

- (1) Electronic trading halts and systems malfunctions;
- (2) Cyber security incidents or targeted threats that actually or potentially jeopardize automated system operation, reliability, security, or capacity; and

(3) Any activation of the designated contract market's business continuity-disaster recovery plan.

(f) A designated contract market must give Commission staff timely advance notice of all:

- (1) Planned changes to automated systems that may impact the reliability, security, or adequate scalable capacity of such systems; and

(2) Planned changes to the designated contract market's program of risk analysis and oversight.

(g) A designated contract market must provide to the Commission upon request current copies of its business continuity-disaster recovery plan and other emergency procedures, its assessments of its operational risks, and other documents requested by Commission staff for the purpose of maintaining a current profile of the designated contract market's automated systems.

(h) A designated contract market must conduct regular, periodic, objective testing and review of its automated systems to ensure that they are reliable, secure, and have adequate scalable capacity. It must also conduct regular, periodic testing and review of its business continuity-disaster recovery capabilities. Both types of testing should be conducted by qualified, independent professionals. Such qualified independent professionals may be independent contractors or employees of the designated contract market, but should not be persons responsible for development or operation of the systems or capabilities being tested. Pursuant to Core Principle 18 (Recordkeeping) and §§ 38.950 and 38.951 of this part, the designated contract market must keep records of all such tests, and make all test results available to the Commission upon request.

(i) To the extent practicable, a designated contract market should:

(1) Coordinate its business continuity-disaster recovery plan with those of the members and other market participants upon whom it depends to provide liquidity, in a manner adequate to enable effective resumption of activity in its markets following a disruption causing activation of the designated contract market's business continuity-disaster recovery plan;

(2) Initiate and coordinate periodic, synchronized testing of its business continuity-disaster recovery plan and the business continuity-disaster recovery plans of the members and other market participants upon whom it depends to provide liquidity; and

(3) Ensure that its business continuity-disaster recovery plan takes into account the business continuity-disaster recovery plans of its telecommunications, power, water, and other essential service providers.

(j) Part 46 of this chapter governs the obligations of those registered entities that the Commission has determined to be critical financial markets, with respect to maintenance and geographic dispersal of disaster recovery resources sufficient to meet a same-day recovery time objective in the event of a wide-scale disruption. Section 40.9 of this chapter establishes the requirements for core principle compliance in that respect.

#### Subpart V—Financial Resources

##### § 38.1100 Core Principle 21.

(a) *In General.* The board of trade shall have adequate financial, operational, and managerial resources to discharge each responsibility of the board of trade.

(b) *Determination of Adequacy.* The financial resources of the board of trade shall be considered to be adequate if the value of the financial resources exceeds the total amount that would enable the contract market to cover the operating costs of the contract market for a 1-year period, as calculated on a rolling basis.

##### § 38.1101 General requirements.

(a) *General rule.* (1) A designated contract market must maintain financial resources sufficient to enable it to perform its functions in compliance with the core principles set forth in Section 5 of the Act and regulations thereunder.

(2) An entity that operates as both a designated contract market and a derivatives clearing organization also shall comply with the financial resource requirements of § 39.11 of this chapter.

(3) Financial resources shall be considered sufficient if their value is at

least equal to a total amount that would enable the designated contract market, or applicant for designation as such, to cover its operating costs for a period of at least one year, calculated on a rolling basis.

(b) *Types of financial resources.* Financial resources available to satisfy the requirements of paragraph (a) of this section may include:

(1) The designated contract market's own capital; and

(2) Any other financial resource deemed acceptable by the Commission.

(c) *Computation of financial resource requirement.* A designated contract market must, on a quarterly basis, based upon its fiscal year, make a reasonable calculation of its projected operating costs over a 12-month period in order to determine the amount needed to meet the requirements of paragraph (a) of this section. The designated contract market shall have reasonable discretion in determining the methodology used to compute such projected operating costs. The Commission may review the methodology and require changes as appropriate.

(d) *Valuation of financial resources.* At appropriate intervals, but not less than quarterly, a designated contract market must compute the current market value of each financial resource used to meet its obligations under paragraph (a) of this section. Reductions in value to reflect market and credit risk ("haircuts") must be applied as appropriate.

(e) *Liquidity of financial resources.* The financial resources allocated by the designated contract market to meet the requirements of paragraph (a) of this section must include unencumbered, liquid financial assets (*i.e.*, cash and/or highly liquid securities) equal to at least six months' operating costs. If any portion of such financial resources is not sufficiently liquid, the designated contract market may take into account a committed line of credit or similar facility for the purpose of meeting this requirement.

(f) *Reporting requirements.* (1) Each fiscal quarter, or at any time upon Commission request, a designated contract market must:

(i) Report to the Commission:  
(A) The amount of financial resources necessary to meet the requirements of paragraph (a) of this section; and

(B) The value of each financial resource available, computed in accordance with the requirements of paragraph (d) of this section; and

(ii) Provide the Commission with a financial statement, including the balance sheet, income statement, and statement of cash flows of the

designated contract market or of its parent company.

(2) The calculations required by this paragraph shall be made as of the last business day of the designated contract market's fiscal quarter.

(3) The designated contract market must provide the Commission with:

(i) Sufficient documentation explaining the methodology used to compute its financial requirements under paragraph (a) of this section,

(ii) Sufficient documentation explaining the basis for its determinations regarding the valuation and liquidity requirements set forth in paragraphs (d) and (e) of this section, and

(iii) Copies of any agreements establishing or amending a credit facility, insurance coverage, or other arrangement evidencing or otherwise supporting the designated contract market's conclusions.

(4) The report shall be filed not later than 17 business days after the end of the designated contract market's fiscal quarter, or at such later time as the Commission may permit, in its discretion, upon request by the designated contract market.

#### **Subpart W—Diversity of Board of Directors**

##### **§ 38.1150 Core Principle 22.**

The board of trade, if a publicly traded company, shall endeavor to recruit individuals to serve on the board of directors and the other decision-making bodies (as determined by the Commission) of the board of trade from among, and to have the composition of the bodies reflect, a broad and culturally diverse pool of qualified candidates.

#### **Subpart X—Securities and Exchange Commission**

##### **§ 38.1200 Core Principle 23.**

The board of trade shall keep any such records relating to swaps defined in Section 1a(47)(A)(v) of the Act open to inspection and examination by the Securities and Exchange Commission.

##### **§ 38.1201 Additional sources for compliance.**

Applicants and designated contract markets may refer to the guidance and/or acceptable practices in Appendix B of this part to demonstrate to the Commission compliance with the requirements of § 38.1200 of this part.

19. Revise appendix A to part 38 to read as follows:

#### **Appendix A—Form DCM lit)**

#### **COMMODITY FUTURES TRADING COMMISSION**

##### *FORM DCM*

#### **CONTRACT MARKET**

#### **APPLICATION OR AMENDMENT TO APPLICATION FOR DESIGNATION**

#### **DESIGNATION INSTRUCTIONS**

Intentional misstatements or material omissions of fact may constitute Federal criminal violations (7 U.S.C. 13 and 18 U.S.C. 1001) or grounds for disqualification from designation.

#### **DEFINITIONS**

Unless the context requires otherwise, all terms used in the Form DCM have the same meaning as in the Commodity Exchange Act, as amended ("CEA" or "Act"), and in the General Rules and Regulations of the Commodity Futures Trading Commission ("Commission") thereunder.

#### **GENERAL INSTRUCTIONS**

1. Application Form DCM and Exhibits thereto are to be filed with the Commission by applicants for designation as a contract market, or by a designated contract market amending such designation, pursuant to Section 5 of the CEA and the Commission's regulations thereunder. Applicants may prepare their own Form DCM but must follow the format prescribed herein. Upon the filing of an application for designation in accordance with the instructions provided herein, the Commission will publish notice of the filing and afford interested persons an opportunity to submit written data, views and arguments concerning such application. No application for designation shall be effective unless the Commission, by order, grants such designation.

2. Individuals' names, except the executing signature in Item 10, shall be given in full (Last Name, First Name, and Middle Name).

3. Signatures on all copies of the Form DCM filed with the Commission can be executed electronically. If the Form DCM is filed by a limited liability company, it must be signed in the name of the limited liability company by a member duly authorized to sign on the limited liability company's behalf; if filed by a partnership, it shall be signed in the name of the partnership by a general partner duly authorized; if filed by an unincorporated organization or association which is not a partnership, it shall be signed in the name of such organization or association by the managing agent—i.e., a duly authorized person who directs or manages or who participates in the directing or managing of its affairs; if filed by a corporation, it shall be signed in the name of the corporation by a principal officer duly authorized.

4. If Form DCM is being filed as an application for designation, all applicable items must be answered in full. If any item is not applicable, indicate by "none," "not applicable," or "N/A" as appropriate.

5. For the purposes of this Form DCM, the term "Applicant" shall include any applicant for designation as a contract market or any designated contract market that is amending Form DCM.

6. Under Section 5 of the CEA and the Commission's regulations thereunder, the Commission is authorized to solicit the information required to be supplied by this Form DCM from Applicants seeking designation as a contract market and from a designated contract market. Disclosure of the information specified on this Form DCM is mandatory prior to the start of processing of an application for designation as a contract market. The information provided with this Form DCM will be used for the principal purpose of determining whether the Commission should grant or deny designation to an Applicant. The Commission further may determine that other and additional information is required from the Applicant in order to process its application. Except in cases where confidential treatment is requested by the Applicant and granted by the Commission, pursuant to the Freedom of Information Act and the rules of the Commission thereunder, information supplied on this Form DCM will be included routinely in the public files of the Commission and will be available for inspection by any interested person. A Form DCM which is not prepared and executed in compliance with applicable requirements and instructions may be returned as not acceptable for filing. Acceptance of this Form DCM, however, shall not constitute a finding that the Form DCM has been filed as required or that the information submitted is true, current or complete.

#### **UPDATING INFORMATION ON THE FORM DCM**

1. Part 38 of the Commission's regulations requires that if any information contained in this application, or any supplement or amendment thereto, is or becomes inaccurate for any reason, an amendment to Form DCM, or a submission under part 40 of the Commission's regulations, in either case correcting such information must be filed promptly with the Commission.

2. Designated Contract Markets filing Form DCM as an amendment need file only the facing page, the signature page (Item 10), and any pages on which an answer is being amended, together with any exhibits that are being amended. The submission of an amendment represents that the remaining items and exhibits remain true, current and complete as previously filed.

#### **WHERE TO FILE**

The Application Form DCM and appropriate exhibits must be filed electronically with the Secretary of the Commission at its Washington DC headquarters at [submissions@cftc.gov](mailto:submissions@cftc.gov) and the Division of Market Oversight at [DMOSubmissions@cftc.gov](mailto:DMOSubmissions@cftc.gov).

**BILLING CODE 6351-01-P**

**COMMODITY FUTURES TRADING COMMISSION****FORM DCM****DESIGNATED CONTRACT MARKET  
APPLICATION OR AMENDMENT TO APPLICATION FOR DESIGNATION**


---

**Exact name of Applicant as specified in charter**

---



---

**Address of principal executive offices**

---

- If this is an **APPLICATION** for designation, complete in full and check here.
- If this is an **AMENDMENT** to an application, or to an existing designation, list all items that are amended and check here.

---



---



---

**GENERAL INFORMATION**

1. Name under which the business of the designated contract market will be conducted, if different than name specified on facing sheet:

---

2. If name of designated contract market is hereby amended, state previous designated contract market name:

---

3. Mailing address, if different than address specified on facing sheet:

---

**Number and Street****City****State****Zip Code**

3(a). Additional contact information:

---

**Fax**


---

**Phone**


---

**Website**

4. List of principal office(s) and address(es) where designated contract market activities are/will be conducted:

Office

Address

---



---

#### **BUSINESS ORGANIZATION**

5. Applicant is a:

- Corporation  
 Partnership  
 Limited Liability Company  
 Other form of organization (specify)

---

6. If Applicant is a corporation:

a. Date of incorporation:

---

b. State of incorporation:

---

7. If Applicant is a partnership:

a. Date of filing of partnership articles:

---

b. State in which filed:

---

8. If Applicant is a limited liability company:

a. Date of filing of Articles of Organization/Certificate of Formation:

---

b. State in which filed:

---

9. Applicant agrees and consents that the notice of any proceeding before the Commission in connection with its application for designation as a contract market may be given by sending such notice by certified mail or confirmed telegram to the officer specified or person named below at the address given.

**Name of person (if Applicant is a corporation, limited liability company or partnership, title of officer)**

---



**Name of Applicant****Number and Street****City****State****Zip Code****SIGNATURES**

10. The Applicant has duly caused this application or amendment to be signed on its behalf by the undersigned, hereunto duly authorized, this \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_. The Applicant and the undersigned represent that all information contained herein is true, current and complete. It is understood that all required items and Exhibits are considered integral parts of this Form DCM and that the submission of any amendment represents that all unamended items and Exhibits remain true, current, and complete as previously filed.

**Name of Applicant****Manual signature of Member, General Partner, Managing Agent, or Principal Agent****Title****BILLING CODE 6351-01-C****EXHIBITS INSTRUCTIONS**

The following exhibits must be filed with the Commission by Applicants seeking designation as a contract market, or by a designated contract market amending its designation, pursuant to Section 5 of the CEA and the Commission's regulations thereunder. The exhibits should be labeled according to the items specified in this Form DCM. If any exhibit is not applicable, please specify the exhibit letter and indicate by "none," "not applicable," or "N/A" as appropriate.

**EXHIBITS—BUSINESS ORGANIZATION**

1. Attach as **Exhibit A**, the name of any person(s) who owns ten percent (10%) or more of the Applicant's stock or who, either directly or indirectly, through agreement or otherwise, in any other manner, may control or direct the management or policies of Applicant.

Provide as part of Exhibit A the full name and address of each such person and attach a copy of the agreement or, if there is none written, describe the agreement or basis upon which such person exercises or may exercise such control or direction.

2. Attach as **Exhibit B**, a list of the present officers, directors, governors (and, in the case of an Applicant that is not a corporation, the members of all standing committees grouped by committee), or persons performing functions similar to any of the foregoing, of the designated contract market or of any entity that performs the regulatory activities of the Applicant, indicating for each:

a. Name

b. Title

c. Dates of commencement and termination of present term of office or position

d. Length of time each present officer, director, or governor has held the same office or position

e. Brief account of the business experience of each officer and director over the last five (5) years

f. Any other business affiliations in the derivatives and securities industry

g. For directors, list any committees on which they serve and any compensation received by virtue of their directorship

h. A description of:

(1) Any order of the Commission with respect to such person pursuant to Section 5e of the CEA;

(2) Any conviction or injunction against such person within the past ten (10) years;

(3) Any disciplinary actions with respect to such person within the last five (5) years;

(4) Any disqualification under Sections 8b and 8d of the CEA;

(5) Any disciplinary action under Section 8c of the CEA; and

(6) Any violation pursuant to Section 9 of the CEA.

3. Attach as **Exhibit C**, a narrative that sets forth the fitness standards for the Board of Directors and its composition including the number and percentage of public directors.

4. Attach as **Exhibit D**, a narrative or graphic description of the organizational structure of the Applicant. Include a list of all affiliates of the Applicant and indicate the general nature of the affiliation. Note: If the designated contract market activities of the Applicant are or will be conducted primarily

by a division, subdivision, or other separate entity within the Applicant, corporation or organization, describe the relationship of such entity within the overall organizational structure and attach as Exhibit D a description only as it applies to the division, subdivision or separate entity, as applicable. Additionally, provide any relevant jurisdictional information, including any and all jurisdictions in which you or any affiliated entity are doing business, and registration status, including pending applications (e.g., country, regulator, registration category, date of registration). Provide the address for legal service of process for each jurisdiction, which cannot be a post office box.

5. Attach as **Exhibit E**, a description of the personnel qualifications for each category of professional employees employed by the Applicant or the division, subdivision, or other separate entity within the Applicant as described in Item 4.

6. Attach as **Exhibit F**, an analysis of staffing requirements necessary to carry out operations of the Applicant as a designated contract market and the name and qualifications of each key staff person.

7. Attach as **Exhibit G**, a copy of the constitution, articles of incorporation, formation or association with all amendments thereto, partnership or limited liability agreements, and existing by-laws, operating agreement, rules or instruments corresponding thereto, of the Applicant. Include any additional governance fitness information not included in Exhibit C. Provide a certificate of good standing dated

within one week of the date of the Form DCM.

8. Attach as **Exhibit H**, a brief description of any pending legal proceeding(s), other than ordinary and routine litigation incidental to the business, to which the Applicant or any of its affiliates is a party or to which any of its or their property is the subject. Include the name of the court or agency where the proceeding(s) are pending, the date(s) instituted, the principal parties involved, a description of the factual basis alleged to underlie the proceeding(s), and the relief sought. Include similar information as to any proceeding(s) known to be contemplated by the governmental agencies.

#### EXHIBITS—FINANCIAL INFORMATION

9. Attach as **Exhibit I**:

a. (i) Balance sheet, (ii) Statement of income and expenses, (iii) Statement of cash flows, and (iv) Statement of sources and application of revenues and all notes or schedules thereto, as of the most recent fiscal year of the Applicant, or of its parent company, if applicable. If a balance sheet and any statements certified by an independent public accountant are available, such balance sheet and statement(s) should be submitted as Exhibit I.

b. Provide a narrative of how the value of the financial resources of the Applicant is at least equal to a total amount that would enable the Applicant to cover its operating costs for a period of at least one year, calculated on a rolling basis, and whether such financial resources include unencumbered, liquid financial assets (i.e. cash and/or highly liquid securities) equal to at least six months' operating costs.

c. Attach copies of any agreements establishing or amending a credit facility, insurance coverage, or other arrangement evidencing or otherwise supporting the Applicant's conclusions regarding the liquidity of its financial assets.

d. Representations regarding sources and estimates for future ongoing operational resources.

10. Attach as **Exhibit J**, a balance sheet and an income and expense statement for each affiliate of the designated contract market that also engages in designated contract market activities as of the end of the most recent fiscal year of each such affiliate, and each affiliate of the designated contract market that engages in swap execution facility activities.

11. Attach as **Exhibit K**, the following:

a. A complete list of all dues, fees and other charges imposed, or to be imposed, by or on behalf of Applicant for its designated contract market services that are provided on an exclusive basis and identify the service or services provided for each such due, fee, or other charge.

b. A description of the basis and methods used in determining the level and structure of the dues, fees and other charges listed in paragraph (a.) of this item.

c. If the Applicant differentiates, or proposes to differentiate, among its customers, or classes of customers in the amount of any dues, fees, or other charges imposed for the same or similar exclusive services, so state and indicate the amount of

each differential. In addition, identify and describe any differences in the cost of providing such services, and any other factors, that account for such differentiations.

#### EXHIBITS—COMPLIANCE

12. Attach as **Exhibit L**, a narrative and supporting documents that may be provided under other Exhibits herein, that describe the manner in which the Applicant is able to comply with each core principle. The Applicant should include an explanation, and any other forms of documentation the Applicant thinks will be helpful to its explanation, demonstrating how the designated contract market will be able to comply with each core principle. To the extent that the application raises issues that are novel, or for which compliance with a core principle is not self-evident, include an explanation of how that item and the application satisfy the core principles.

13. Attach as **Exhibit M**, a copy of the Applicant's rules (as defined in § 40.1 of the Commission's regulations) and any technical manuals, other guides or instructions for users of, or participants in, the market, including minimum financial standards for members or market participants. Include rules citing applicable Federal position limits and aggregation standards in part 151 of the Commission's regulations and any exchange set position limit rules. Include rules on publication of daily trading information with regards to the requirements of part 16 of the Commission's regulations. The Applicant should include an explanation, and other forms of documentation the Applicant thinks will be helpful to its explanation, demonstrating how the designated contract market will be able to comply with each core principle and how its rules, technical manuals, other guides or instructions for users of, or participants in, the market, or minimum financial standards for members of market participants as provided in this Exhibit M help support the designated contract market's compliance with the core principles.

14. Attach as **Exhibit N**, executed or executable copies of any agreements or contracts entered into or to be entered into by the Applicant, including third party regulatory service provider or member or user agreements that enable or empower the Applicant to comply with applicable core principles. Identify: (1) The services that will be provided; and (2) The core principles addressed by such agreement.

15. Attach as **Exhibit O**, a copy of any compliance manual and any other documents that describe with specificity, the manner in which the Applicant will conduct trade practice, market and financial surveillance.

16. Attach as **Exhibit P**, a description of the Applicant's disciplinary and enforcement protocols, tools, and procedures and the arrangements for alternative dispute resolution.

17. Attach as **Exhibit Q**, a description of the Applicant's trade matching algorithm and examples of how that algorithm works in various trading scenarios involving various types of orders.

18. Attach as **Exhibit R**, a list of rules prohibiting specific trade practice violations.

19. Attach as **Exhibit S**, a discussion of how trading data will be maintained by the designated contract market.

20. Attach as **Exhibit T**, a list of the name of the clearing organization(s) that will be clearing the Applicant's trades, and a representation that clearing members of that organization will be guaranteeing such trades.

21. Attach as **Exhibit U**, any information (described with particularity) included in the application that will be subject to a request for confidential treatment pursuant to § 145.9 of the Commission's regulations.

#### EXHIBITS—OPERATIONAL CAPABILITY

22. Attach as **Exhibit V**, information responsive to the Technology Questionnaire (hyperlink to Web site). This questionnaire focuses on information pertaining to the Applicant's program of risk analysis and oversight. Main topic areas include: information security; business continuity-disaster recovery ("BC-DR") planning and resources; capacity and performance planning; systems operations; systems development and quality assurance; and physical security and environmental controls.

20. Revise Appendix B to part 38 to read as follows:

#### Appendix B to Part 38—Guidance on, and Acceptable Practices in, Compliance With Core Principles

1. This appendix provides guidance on complying with core principles, both initially and on an ongoing basis, to obtain and maintain designation under Section 5(d) of the Act and this part 38. Where provided, guidance is set forth in paragraph (a) following the relevant heading and can be used to demonstrate to the Commission compliance with the selected requirements of a core principle, under §§ 38.3 and 38.5 of this part. The guidance for the core principle is illustrative only of the types of matters a designated contract market may address, as applicable, and is not intended to be used as a mandatory checklist. Addressing the issues set forth in this appendix would help the Commission in its consideration of whether the designated contract market is in compliance with the selected requirements of a core principle; *provided however*, that the guidance is not intended to diminish or replace, in any event, the obligations and requirements of applicants and designated contract markets to comply with the regulations provided under this part.

2. Where provided, acceptable practices meeting selected requirements of core principles are set forth in paragraph (b) following guidance. Designated contract markets that follow specific practices outlined in the acceptable practices for a core principle in this appendix will meet the selected requirements of the applicable core principle; *provided however*, that the acceptable practice is not intended to diminish or replace, in any event, the obligations and requirements of applicants and designated contract markets to comply with the regulations provided under this part 38. The acceptable practices are for

illustrative purposes only and do not state the exclusive means for satisfying a core principle.

**Core Principle 1 of section 5(d) of the Act: DESIGNATION AS CONTRACT MARKET.—**

(A) IN GENERAL.—To be designated, and maintain a designation, as a contract market, a board of trade shall comply with—

- (i) any core principle described in this subsection; and
- (ii) any requirement that the Commission may impose by rule or regulation pursuant to section 8a(5).

(B) REASONABLE DISCRETION OF CONTRACT MARKET.—Unless otherwise determined by the Commission by rule or regulation, a board of trade described in subparagraph (A) shall have reasonable discretion in establishing the manner in which the board of trade complies with the core principles described in this subsection.

(a) *Guidance*. [Reserved.]

(b) *Acceptable Practices*. [Reserved.]

**Core Principle 2 of section 5(d) of the Act: COMPLIANCE WITH RULES.—**

(A) IN GENERAL.—The board of trade shall establish, monitor, and enforce compliance with the rules of the contract market, including—

- (i) access requirements;
- (ii) the terms and conditions of any contracts to be traded on the contract market; and
- (iii) rules prohibiting abusive trade practices on the contract market.

(B) CAPACITY OF CONTRACT MARKET.—The board of trade shall have the capacity to detect, investigate, and apply appropriate sanctions to any person that violates any rule of the contract market.

(C) REQUIREMENT OF RULES.—The rules of the contract market shall provide the board of trade with the ability and authority to obtain any necessary information to perform any function described in this subsection, including the capacity to carry out such international information-sharing agreements as the Commission may require.

(a) *Guidance*. [Reserved.]

(b) *Acceptable Practices*. [Reserved.]

**Core Principle 3 of section 5(d) of the Act: CONTRACTS NOT READILY SUBJECT TO MANIPULATION.—**The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.

(a) *Guidance*. (1) Designated contract markets may list new products for trading by self-certification under § 40.2 of this chapter or may submit products for Commission approval under § 40.3 of this chapter.

(2) Guidance in appendix C to this part may be used as guidance in meeting this core principle for both new products listings and existing listed contracts.

(b) *Acceptable Practices*. [Reserved.]

**Core Principle 4 of section 5(d) of the Act: PREVENTION OF MARKET DISRUPTION.—**

The board of trade shall have the capacity and responsibility to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process through market surveillance, compliance, and enforcement practices and procedures, including—

(A) methods for conducting real-time monitoring of trading; and

(B) comprehensive and accurate trade reconstructions.

(a) *Guidance*. [Reserved.]

(b) *Acceptable Practices*. [Reserved.]

**Core Principle 5 of section 5(d) of the Act: POSITION LIMITATIONS OR ACCOUNTABILITY.—**(A) IN GENERAL.—To reduce the potential threat of market manipulation or congestion (especially during trading in the delivery month), the board of trade shall adopt for each contract of the board of trade, as is necessary and appropriate, position limitations or position accountability for speculators.

(B) MAXIMUM ALLOWABLE POSITION LIMITATION.—For any contract that is subject to a position limitation established by the Commission pursuant to section 4a(a), the board of trade shall set the position limitation of the board of trade at a level not higher than the position limitation established by the Commission.

(a) *Guidance*. [Reserved.]

(b) *Acceptable Practices*. [Reserved.]

**Core Principle 6 of section 5(d) of the Act: EMERGENCY AUTHORITY.—**The board of trade, in consultation or cooperation with the Commission, shall adopt rules to provide for the exercise of emergency authority, as is necessary and appropriate, including the authority—

(A) to liquidate or transfer open positions in any contract;

(B) to suspend or curtail trading in any contract; and

(C) to require market participants in any contract to meet special margin requirements.

(a) *Guidance*. In consultation and cooperation with the Commission, a designated contract market should have the authority to intervene as necessary to maintain markets with fair and orderly trading and to prevent or address manipulation or disruptive trading practices, whether the need for intervention arises exclusively from the DCM's market or as part of a coordinated, cross-market intervention. DCM rules should include procedures and guidelines to avoid conflicts of interest in accordance with the provisions of § 40.9 of this chapter, and include alternate lines of communication and approval procedures to address emergencies associated with real time events. To address perceived market threats, the designated contract market should have rules that allow it to take certain actions in the event of an emergency, as defined in § 40.1(h) of this chapter, including: imposing or modifying position limits, price limits, and intraday market restrictions; imposing special margin requirements; ordering the liquidation or transfer of open positions in any contract; ordering the fixing of a settlement price; extending or shortening the expiration date or the trading hours; suspending or curtailing trading in any contract; transferring customer contracts and the margin or altering any contract's settlement terms or conditions; and, where applicable, providing for the carrying out of such actions through its agreements with its third-party provider of clearing or regulatory services. In situations where a swap is traded on more than one platform, emergency action to liquidate or transfer open interest must be as directed, or

agreed to, by the Commission or the Commission's staff. The Commission should be notified promptly of the DCM's exercise of emergency action, explaining how conflicts of interest were minimized, including the extent to which the DCM considered the effect of its emergency action on the underlying markets and on markets that are linked or referenced to the contract market and similar markets on other trading venues. Information on all regulatory actions carried out pursuant to a DCM's emergency authority should be included in a timely submission of a certified rule pursuant to part 40 of this chapter.

(b) *Acceptable Practices*. A designated contract market must have procedures and guidelines for decision-making and implementation of emergency intervention in the market. At a minimum, the DCM must have the authority to liquidate or transfer open positions in the market, suspend or curtail trading in any contract, and require market participants in any contract to meet special margin requirements. In situations where a swap is traded on more than one platform, emergency action to liquidate or transfer open interest must be directed, or agreed to, by the Commission or the Commission's staff. The DCM must promptly notify the Commission of the exercise of its emergency authority, documenting its decision-making process, including how conflicts of interest were minimized, and the reasons for using its emergency authority. The DCM must also have rules that allow it to take such market actions as may be directed by the Commission.

**Core Principle 7 of section 5(d) of the Act: AVAILABILITY OF GENERAL INFORMATION.—**The board of trade shall make available to market authorities, market participants, and the public accurate information concerning—

(A) the terms and conditions of the contracts of the contract market; and

(B)(i) the rules, regulations, and mechanisms for executing transactions on or through the facilities of the contract market; and

(ii) the rules and specifications describing the operation of the contract market's—

(I) electronic matching platform; or

(II) trade execution facility.

(a) *Guidance*. [Reserved.]

(b) *Acceptable Practices*. [Reserved.]

**Core Principle 8 of section 5(d) of the Act: DAILY PUBLICATION OF TRADING INFORMATION.—**The board of trade shall make public daily information on settlement prices, volume, open interest, and opening and closing ranges for actively traded contracts on the contract market.

(a) *Guidance*. [Reserved.]

(b) *Acceptable Practices*. [Reserved.]

**Core Principle 9 of section 5(d) of the Act: EXECUTION OF TRANSACTIONS.—**(A) IN GENERAL.—The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market of the board of trade.

(B) RULES.—The rules of the board of trade may authorize, for bona fide business purposes—

(i) transfer trades or office trades;  
 (ii) an exchange of—  
 (I) futures in connection with a cash commodity transaction;  
 (II) futures for cash commodities; or  
 (III) futures for swaps; or  
 (iii) a futures commission merchant, acting as principal or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if the contract is reported, recorded, or cleared in accordance with the rules of the contract market or a derivatives clearing organization.

(a) *Guidance.* [Reserved.]

(b) *Acceptable Practices.* (1) *Block size determination for existing contracts.* For any futures contract that has been trading for one calendar quarter or longer, the acceptable minimum block trade size should be a number larger than the size at which a single buy or sell order is customarily able to be filled in its entirety in that product's centralized market without incurring a substantial price concession. In specifying the minimum block, the designated contract market should consider, and the Commission will review, data related to factors including: the trading volume, open interest, liquidity and depth of the order book, typical trade and order sizes in the market, any input the designated contract market receives from brokers, floor traders and/or market users related to these factors, and the block sizes on comparable swap products.

(2) *Block size determination for new contracts.* For any futures contract that has been listed for trading for less than one calendar quarter, an acceptable minimum block trade size should be a number equal to the size of a trade that the exchange reasonably anticipates will not be able to be filled in its entirety in that product's centralized market without incurring a substantial price concession. In reviewing the block size for these products, the designated contract market should consider, and the Commission will review: centralized market data in a related futures contract, the same contract traded on another exchange, trading activity in the underlying cash market, and the block sizes on comparable swap products. For both existing and new contracts, the designated contract market may consider other relevant factors, but must present those factors to the Commission when it certifies or seeks approval of the block trade size.

(3) *Pricing of block trades.* (i) Block trades must be at a price that is fair and reasonable. In determining whether a block trade price is fair and reasonable, the DCM should consider: (A) the size of the block; (B) the price and size of other block trades in any relevant markets at the applicable time; and/or (C) the circumstance of the market or the parties to the block trade. Relevant markets include the designated contract market itself, the underlying cash markets, and/or related futures or options markets. (ii) Block trades between affiliated parties are subject to the pricing requirements set forth in § 38.503(d) of this part.

(4) *Recordkeeping for block trades.* Records kept in accordance with the requirements of FASB Statement No. 133 ("Accounting for Derivative Instruments and Hedging

Activities"), as amended by FASB Statement No. 161 ("Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133") are acceptable records.

**Core Principle 10 of section 5(d) of the Act: TRADE INFORMATION.**—The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information—

(A) to assist in the prevention of customer and market abuses; and

(B) to provide evidence of any violations of the rules of the contract market.

(a) *Guidance.* [Reserved.]

(b) *Acceptable Practices.* [Reserved.]

**Core Principle 11 of section 5(d) of the Act: FINANCIAL INTEGRITY OF TRANSACTIONS.**—The board of trade shall establish and enforce—

(A) rules and procedures for ensuring the financial integrity of transactions entered into on or through the facilities of the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization); and

(B) rules to ensure—

(i) the financial integrity of any—

(I) futures commission merchant; and

(II) introducing broker; and

(ii) the protection of customer funds.

(a) *Guidance.* [Reserved.]

(b) *Acceptable Practices.* [Reserved.]

**Core Principle 12 of section 5(d) of the Act: PROTECTION OF MARKETS AND MARKET PARTICIPANTS.**—The board of trade shall establish and enforce rules—

(A) to protect markets and market participants from abusive practices committed by any party, including abusive practices committed by a party acting as an agent for a participant; and

(B) to promote fair and equitable trading on the contract market.

(a) *Guidance.* [Reserved.]

(b) *Acceptable Practices.* [Reserved.]

**Core Principle 13 of section 5(d) of the Act: DISCIPLINARY PROCEDURES.**—The board of trade shall establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market participants that violate the rules of the board of trade, or similar methods for performing the same functions, including delegation of the functions to third parties.

(a) *Guidance.* [Reserved.]

(b) *Acceptable Practices.* [Reserved.]

**Core Principle 14 of section 5(d) of the Act: DISPUTE RESOLUTION.**—The board of trade shall establish and enforce rules regarding, and provide facilities for alternative dispute resolution as appropriate for, market participants and any market intermediaries.

(a) *Guidance.* A designated contract market should provide customer dispute resolution procedures that are: appropriate to the nature of the market; fair and equitable; and available on a voluntary basis, either directly or through another self-regulatory organization, to customers that are non-eligible contract participants.

(b) *Acceptable Practices.*

(1) *Fair and equitable procedure.* Every contract market shall provide customer

dispute resolution procedures that are fair and equitable. An acceptable customer dispute resolution mechanism would:

(i) Provide the customer with an opportunity to have his or her claim decided by an objective and impartial decision-maker;

(ii) Provide each party with the right to be represented by counsel at the commencement of the procedure, at the party's own expense;

(iii) Provide each party with adequate notice of the claims presented against such party, an opportunity to be heard on all claims, defenses and permitted counterclaims, and an opportunity for a prompt hearing;

(iv) Authorize prompt, written, final settlement awards that are not subject to appeal within the designated contract market; and

(v) Notify the parties of the fees and costs that may be assessed.

(2) *Voluntary Procedures.* The use of dispute settlement procedures shall be voluntary for customers other than eligible contract participants as defined in section 1a(18) of the Act, and may permit counterclaims as provided in § 166.5 of this chapter.

(3) *Member-to-Member Procedures.* If the designated contract market also provides procedures for the resolution of disputes that do not involve customers (i.e., member-to-member disputes), the procedures for resolving such disputes must be independent of and shall not interfere with or delay the resolution of customers' claims or grievances.

(4) *Delegation.* A designated contract market may delegate to another self-regulatory organization or to a registered futures association its responsibility to provide for customer dispute resolution mechanisms, provided, however, that in the event of such delegation, the designated contract market shall in all respects treat any decision issued by such other organization or association with respect to such dispute as if the decision were its own, including providing for the appropriate enforcement of any award issued against a delinquent member.

**Core Principle 15 of section 5(d) of the Act: GOVERNANCE FITNESS STANDARDS.**—The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other person with direct access to the facility (including any party affiliated with any person described in this paragraph).

(a) *Guidance.* [Reserved.]

(b) *Applicable Practices.* [Reserved.]

**Core Principle 16 of section 5(d) of the Act: CONFLICTS OF INTEREST.**—The board of trade shall establish and enforce rules—

(A) to minimize conflicts of interest in the decision making process of the contract market; and

(B) to establish a process for resolving conflicts of interest described in subparagraph (A).

(a) *Guidance.* [Reserved.]

(b) *Acceptable Practices.* [Reserved.]

**Core Principle 17 of section 5(d) of the Act: COMPOSITION OF GOVERNING BOARDS OF CONTRACT MARKETS.**—The governance arrangements of the board of

trade shall be designed to permit consideration of the views of market participants.

(a) *Guidance.* [Reserved.]

(b) *Acceptable Practices.* [Reserved.]

**Core Principle 18 of section 5(d) of the Act:** RECORDKEEPING.—The board of trade shall maintain records of all activities relating to the business of the contract market—

(A) in a form and manner that is acceptable to the Commission; and

(B) for a period of at least 5 years.

(a) *Guidance.* [Reserved.]

(b) *Acceptable Practices.* [Reserved.]

**Core Principle 19 of section 5(d) of the Act:** ANTITRUST CONSIDERATIONS.—Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall not—

(A) adopt any rule or taking any action that results in any unreasonable restraint of trade; or

(B) impose any material anticompetitive burden on trading on the contract market.

(a) *Guidance.* An entity seeking designation as a contract market may request that the Commission consider under the provisions of section 15(b) of the Act, any of the entity's rules, including trading protocols or policies, and including both operational rules and the terms or conditions of products listed for trading, at the time of designation or thereafter. The Commission intends to apply section 15(b) of the Act to its consideration of issues under this core principle in a manner consistent with that previously applied to contract markets.

(b) *Acceptable Practices.* [Reserved.]

**Core Principle 20 of section 5(d) of the Act:** SYSTEM SAFEGUARDS.—The board of trade shall—

(A) establish and maintain a program of risk analysis and oversight to identify and minimize sources of operational risk, through the development of appropriate controls and procedures, and the development of automated systems, that are reliable, secure, and have adequate scalable capacity;

(B) establish and maintain emergency procedures, backup facilities, and a plan for disaster recovery that allow for the timely recovery and resumption of operations and the fulfillment of the responsibilities and obligations of the board of trade; and

(C) periodically conduct tests to verify that backup resources are sufficient to ensure continued order processing and trade matching, price reporting, market surveillance, and maintenance of a comprehensive and accurate audit trail.

(a) *Guidance.* [Reserved.]

(b) *Acceptable Practices.* [Reserved.]

**Core Principle 21 of section 5(d) of the Act:** FINANCIAL RESOURCES.—

(A) IN GENERAL.—The board of trade shall have adequate financial, operational, and managerial resources to discharge each responsibility of the board of trade.

(B) DETERMINATION OF ADEQUACY.—The financial resources of the board of trade shall be considered to be adequate if the value of the financial resources exceeds the total amount that would enable the contract market to cover the operating costs of the contract market for a 1-year period, as calculated on a rolling basis.

(a) *Guidance.* [Reserved.]

(b) *Acceptable Practices.* [Reserved.]

**Core Principle 22 of section 5(d) of the Act:** DIVERSITY OF BOARD OF DIRECTORS.—The board of trade, if a publicly traded company, shall endeavor to recruit individuals to serve on the board of directors and the other decision-making bodies (as determined by the Commission) of the board of trade from among, and to have the composition of the bodies reflect, a broad and culturally diverse pool of qualified candidates.

(a) *Guidance.* [Reserved.]

(b) *Acceptable Practices.* [Reserved.]

**Core Principle 23 of section 5(d) of the Act:** SECURITIES AND EXCHANGE COMMISSION.—The board of trade shall keep any such records relating to swaps defined in section 1a(47)(A)(v) open to inspection and examination by the Securities and Exchange Commission.

(a) *Guidance.* A designated contract market should have arrangements and resources for collecting and maintaining accurate records pertaining to any swaps agreements defined in section 1a(47)(A)(v) of the Act.

(b) *Acceptable Practices.* [Reserved.]

21. Add appendix C to part 38 to read as follows:

#### **Appendix C—Demonstration of Compliance That a Contract is not Readily Susceptible to Manipulation**

(a) *Futures Contracts—General Information.* When a designated contract market certifies or submits for approval contract terms and conditions for a new futures contract, that submission must include the following information:

(1) A narrative describing the contract, including data and information to support the contract's terms and conditions, as set by the designated contract market. When designing a futures contract, the designated contract market should conduct market research so that the contract design meets the risk management needs of prospective users and promotes price discovery of the underlying commodity. The designated contract market should consult with market users to obtain their views and opinions during the contract design process to ensure the contract's term and conditions reflect the underlying cash market and that the futures contract will perform the intended risk management and/or price discovery functions. A designated contract market should provide a statement indicating that it took such steps to ensure the usefulness of the submitted contract.

(2) A detailed cash market description for physical and cash-settled contracts should be included. Such descriptions must be based on government and/or other publically-available data whenever possible and be formulated for both the national and regional/local market relevant to the underlying commodity. For tangible commodities, the cash market descriptions for the relevant market (i.e., national and regional/local) must incorporate at least five full years of data that may include, among other factors, production, consumption, stocks, imports, exports, and prices. Each of

those cash market variables must be fully defined and the data sources must be fully specified and documented to permit Commission staff to replicate the estimates of deliverable supply (defined in paragraph (b)(1)(A) of this appendix C). Whenever possible, the Commission requests that monthly or daily prices (depending on the contract) underlying the cash settlement index be submitted for the most recent five full calendar years and for as many of the current year's months for which data are available. For contracts that are cash settled to an index, the index's methodology must be provided along with supporting information showing how the index is reflective of the underlying cash market, is not readily subject to manipulation or distortion, and is based on a cash price series that is reliable, acceptable, publicly available and timely (defined in paragraphs (c)(2) and (c)(3) of this appendix C). The Commission recognizes that the data necessary for accurate and cogent cash market analyses for an underlying commodity vary with the nature of the underlying commodity. The Commission may require that the designated contract market submit a detailed report on commodity definitions and uses.

(b) *Futures Contracts Settled by Physical Delivery.* (1) For listed contracts that are settled by physical delivery, the terms and conditions of the contract should conform to the most common commercial practices and conditions in the cash market for the commodity underlying the futures contract. The terms and conditions should be designed to avoid any impediments to the delivery of the commodity so as to promote convergence between the price of the futures contract and the cash market value of the commodity at the expiration of a futures contract.

(i) *Estimating Deliverable Supplies.*

(A) *General definition.* The specified terms and conditions, considered as a whole, must result in a "deliverable supply" that is sufficient to ensure that the contract is not susceptible to price manipulation or distortion. In general, the term "deliverable supply" means the quantity of the commodity meeting the contract's delivery specifications that reasonably can be expected to be readily available to short traders and salable by long traders at its market value in normal cash marketing channels at the contract's delivery points during the specified delivery period, barring abnormal movement in interstate commerce. Typically, deliverable supply reflects the quantity of the commodity that potentially could be made available for sale on a spot basis at current prices at the contract's delivery points. For a non-financial physical-delivery commodity contract, this estimate might represent product which is in storage at the delivery point(s) specified in the futures contract or can be moved economically into or through such points consistent with the delivery procedures set forth in the contract and which is available for sale on a spot basis within the marketing channels that normally are tributary to the delivery point(s). Furthermore, an appropriate estimate of deliverable supply excludes commodity supplies that are committed to some commercial use. The size of commodity supplies that are committed to

some commercial use may be estimated by consulting with market participants. An adequate measure of deliverable supply would be an amount of the commodity that would meet the normal or expected range of delivery demand without causing futures prices to become distorted relative to cash market prices. Given the availability of acceptable data, deliverable supply should be estimated on a monthly basis for at least the most recent five years for which data are available. To the extent possible and that data resources permit, deliverable supply estimates should be constructed such that the data reflect, as close as possible, the market defined by the contract's terms and conditions, and should be formulated, whenever possible, with government or publically available data. All deliverable supply estimates must be fully defined, have all underlying assumptions explicitly stated, and have documentation of all data/information sources in order to permit estimate replication by Commission staff.

(B) *Accounting for variations in deliverable supplies.* To assure the availability of adequate deliverable supplies and acceptable levels of commercial risk management utility, contract terms and conditions should account for variations in the patterns of production, consumption and supply over a period of years of sufficient length to assess adequately the potential range of deliverable supplies. This assessment also should consider seasonality, growth, and market concentration in the production/consumption of the underlying cash commodity. Deliverable supply implications of seasonal effects are more straightforwardly delineated when deliverable supply estimates are calculated on a monthly basis and when such monthly estimates are provided for at least the most recent five years for which data resources permit. In addition, consideration should be given to the relative roles of producers, merchants, and consumers in the production, distribution, and consumption of the cash commodity and whether the underlying commodity exhibits a domestic or international export focus. Careful consideration also should be given to the quality of the cash commodity and to the movement or flow of the cash commodity in normal commercial channels and whether there exist external factors or regulatory controls that could affect the price or supply of the cash commodity.

(C) *Calculation of deliverable supplies.* Designated contract markets should derive a quantitative estimate of the deliverable supplies for the delivery period specified in the proposed contract. For commodities with seasonal supply or demand characteristics, the deliverable supply analysis should include that period when potential supplies typically are at their lowest levels. The estimate should be based on statistical data, when reasonably available, covering a period of time that is representative of the underlying commodity's actual patterns of production, patterns of consumption, and patterns of seasonal effects (if relevant). Often, such a relevant time period should include at least five years of monthly deliverable supply estimates permitted by

available data resources. Deliverable supply estimates should also exclude the amount of the commodity that would not be otherwise deliverable on the futures contract. For example, deliverable supplies should exclude quantities that at current price levels are not economically obtainable or deliverable or were previously dedicated under contract for commercial use.

(2) *Contract Terms and Conditions Requirements for Futures Contracts Settled by Physical Delivery.*

(i) For physical delivery contracts, an acceptable specification of terms and conditions would include, but may not be limited to, rules that address, as appropriate, the following criteria and comply with the associated standards:

(A) *Quality Standards:* The terms and conditions of a commodity contract should describe or define all of the economically significant characteristics or attributes of the commodity underlying the contract. In particular, the quality standards should be described or defined so that such standards reflect those used in transactions in the commodity in normal cash marketing channels. Documentation establishing that the quality standards of the contract's underlying commodity comply with those accepted/established by the industry, by Government regulations, and/or by relevant laws should also be submitted. For any particular commodity contract, the specific attributes that must be enumerated depend upon the individual characteristics of the underlying commodity. These may include, for example, the following items: grade, quality, purity, weight, class, origin, growth, issuer, originator, maturity window, coupon rate, source, hours of trading, etc. If the terms of the contract provide for the delivery of multiple qualities of a specific attribute of the commodity having different cash market values, then a "par" quality should be specified with price differentials applicable to the "non-par" qualities that reflect discounts or premiums commonly observed or expected to occur in the cash market for that commodity.

(B) *Delivery Points and Facilities:* Delivery point/area specifications should provide for futures delivery at a single location or at multiple locations where the underlying cash commodity is normally transacted or stored and where there exists a viable cash market(s). If multiple delivery points are specified and the value of the commodity differs between these locations, contract terms should include price differentials that reflect usual differences in value between the different delivery locations. If the price relationships among the delivery points are unstable and a designated contract market chooses to adopt fixed locational price differentials, such differentials should fall within the range of commonly observed or expected commercial price differences. In this regard, any price differentials must be supported with cash price data for the delivery location(s). The terms and conditions of the contracts also should specify, as appropriate, any conditions the delivery facilities and/or delivery facility operators must meet in order to be eligible for delivery. Specification of any requirements

for delivery facilities also should consider the extent to which ownership of such facilities is concentrated and whether the level of concentration would be susceptible to manipulation of the futures contract's prices. Commodity contracts also should specify appropriately detailed delivery procedures that describe the responsibilities of deliverers, receivers and any required third parties in carrying out the delivery process. Such responsibilities could include allocation between buyer and seller of all associated costs such as load-out, document preparation, sampling, grading, weighing, storage, taxes, duties, fees, drayage, stevedoring, demurrage, dispatch, etc. Required accreditation for third-parties also should be detailed. These procedures should seek to minimize or eliminate any impediments to making or taking delivery by both deliverers and takers of delivery to help ensure convergence of cash and futures at the expiration of a futures delivery month.

(C) *Delivery Period and Last Trading Day:* An acceptable specification of the delivery period would allow for sufficient time for deliverers to acquire the deliverable commodity and make it available for delivery, considering any restrictions or requirements imposed by the designated contract market. Specification of the last trading day for expiring contracts should consider whether adequate time remains after the last trading day to allow for delivery on the contract.

(D) *Contract Size and Trading Unit:* An acceptable specification of the delivery unit and/or trading unit would be a contract size that is consistent with customary transactions, transportation or storage amounts in the cash market (e.g., the contract size may be reflective of the amount of the commodity that represents a pipeline, truckload or railcar shipment). For purposes of increasing market liquidity, a designated contract market may elect to specify a contract size that is smaller than the typical commercial transaction size, storage unit or transportation size. In such cases, the commodity contract should include procedures that allow futures traders to easily take or make delivery on such a contract with a smaller size, or, alternatively, the designated contract market may adopt special provisions requiring that delivery be made only in multiple contracts to accommodate reselling the commodity in the cash market. If the latter provision is adopted, contract terms should be adopted to minimize the potential for default in the delivery process by ensuring that all contracts remaining open at the close of trading in expiring delivery months can be combined to meet the required delivery unit size. Generally, contract sizes and trading units must be determined after a careful analysis of relevant cash market trading practices, conditions and deliverable supply estimates, so as to ensure that the underlying market commodity market and available supply sources are able to support the contract sizes and trading units at all times.

(E) *Delivery Pack:* The term "delivery pack" refers to the packaging standards (e.g., product may be delivered in burlap or polyethylene bags stacked on wooden

pallets) or non-quality related standards regarding the composition of commodity within a delivery unit (e.g., product must all be imported from the same country or origin). An acceptable specification of the delivery pack or composition of a contract's delivery unit should reflect, to the extent possible, specifications commonly applied to the commodity traded or transacted in the cash market.

(F) *Delivery Instrument*: An acceptable specification of the delivery instrument (e.g., warehouse receipt, depository certificate or receipt, shipping certificate, bill of lading, in-line transfer, book transfer of securities, etc.) would provide for its conversion into the cash commodity at a commercially-reasonable cost. Transportation terms (e.g., FOB, CIF, freight prepaid to destination) as well as any limits on storage or certificate daily premium fees should be specified. These terms should reflect cash market practices and the customary provision for allocating delivery costs between buyer and seller.

(G) *Inspection Provisions*: Any inspection/certification procedures for verifying compliance with quality requirements or any other related delivery requirements (e.g., discounts relating to the age of the commodity, etc.) should be specified in the contract rules. An acceptable specification of inspection procedures would include the establishment of formal procedures that are consistent with procedures used in the cash market. To the extent that formal inspection procedures are not used in the cash market, an acceptable specification would contain provisions that assure accuracy in assessing the commodity, that are available at a low cost, that do not pose an obstacle to delivery on the contract and that are performed by a reputable, disinterested third party or by qualified designated contract market employees. Inspection terms also should detail which party pays for the service, particularly in light of the possibility of varying inspection results.

(H) *Delivery (Trading) Months*: Delivery months should be established based on the risk management needs of commercial entities as well as the availability of deliverable supplies in the specified months.

(I) *Minimum Price Fluctuation (Minimum Tick)*: The minimum price increment (tick) should be set at a level that is equal to, or less than, the minimum price increment commonly observed in cash market transactions for the underlying commodity. Specifying a futures' minimum tick that is greater than the minimum price increment in the cash market can undermine the risk management utility of the futures contract by preventing hedgers from efficiently establishing and liquidating futures positions that are used to hedge anticipated cash market transactions or cash market positions.

(J) *Maximum Price Fluctuation Limits*: Designated contract markets may adopt price limits to: (1) Reduce or constrain price movements in a trading day that may not be reflective of true market conditions but might be caused by traders overreacting to news; (2) Allow additional time for the collection of margins in times of large price movements; and (3) Provide a "cooling-off" period for

futures market participants to respond to bona fide changes in market supply and demand fundamentals that would lead to large cash and futures price changes. If price limit provisions are adopted, the limits should be set at levels that are not overly restrictive in relation to price movements in the cash market for the commodity underlying the futures contract.

(K) *Speculative Limits*: Specific information regarding the establishment of speculative position limits are set forth in part 151 of the Commission's regulations.

(L) *Reportable Levels*: Refer to § 15.03 of the Commission's regulations.

(M) *Trading Hours*: Should be set by the designated contract market to delineate each trading day.

(c) *Futures Contracts Settled by Cash Settlement*. (1) Cash settlement is a method of settling certain futures or option contracts whereby, at contract expiration, the contract is settled by cash payment in lieu of physical delivery of the commodity or instrument underlying the contract. An acceptable specification of the cash settlement price for commodity futures and option contracts would include rules that fully describe the essential economic characteristics of the underlying commodity (e.g., grade, quality, weight, class, growth, issuer, maturity, source, rating, description of the underlying index and index's calculation methodology, etc.), as well as how the final settlement price is calculated. In addition, the rules should clearly specify the trading months and hours of trading, the last trading day, contract size, minimum price change (tick size) and any limitations on price movements (e.g., price limits or trading halts).

(2) Cash settled contracts may be susceptible to manipulation or price distortion. In evaluating the susceptibility of a cash-settled contract to manipulation, a designated contract market must consider the size and liquidity of the cash market that underlies the listed contract. In particular, situations susceptible to manipulation include those in which the volume of cash market transactions and/or the number of participants contacted in determining the cash-settlement price are very low. Cash-settled contracts may create an incentive to manipulate or artificially influence the data from which the cash-settlement price is derived or to exert undue influence on the cash-settlement price's computation in order to profit on a futures position in that commodity. The utility of a cash-settled contract for risk management and price discovery would be significantly impaired if the cash settlement price is not a reliable or robust indicator of the value of the underlying commodity or instrument. Accordingly, careful consideration should be given to the potential for manipulation or distortion of the cash settlement price, as well as the reliability of that price as an indicator of cash market values. Appropriate consideration also should be given to the commercial acceptability, public availability, and timeliness of the price series that is used to calculate the cash settlement price. Documentation demonstrating that the settlement price index is a reliable indicator of market values and conditions and is

commonly used as a reference index by industry/market agents should be provided. Such documentation may take on various forms, including carefully documented interview results with knowledgeable agents.

(3) Where an independent, private-sector third party calculates the cash settlement price series, a designated contract market must consider the need for a licensing agreement that will ensure the designated contract market's rights to the use of the price series to settle the listed contract.

(i) Where an independent, private-sector third party calculates the cash settlement price series, the designated contract market should verify that the third party utilizes business practices that minimize the opportunity or incentive to manipulate the cash-settlement price series. Such safeguards may include lock-downs, prohibitions against derivatives trading by employees, or public dissemination of the names of sources and the price quotes they provide. Because a cash-settled contract may create an incentive to manipulate or artificially influence the underlying market from which the cash-settlement price is derived or to exert undue influence on the cash-settlement computation in order to profit on a futures position in that commodity, a designated contract market should, whenever practicable, enter into an information-sharing agreement with the third-party provider which would enable the designated contract market to better detect and prevent manipulative behavior.

(ii) Where a designated contract market itself generates the cash settlement price series, the designated contract market should establish calculation procedures that safeguard against potential attempts to artificially influence the price. For example, if the cash settlement price is derived by the designated contract market based on a survey of cash market sources, the designated contract market should maintain a list of such entities which all should be reputable sources with knowledge of the cash market. In addition, the sample of sources polled should be representative of the cash market, and the poll should be conducted at a time when trading in the cash market is active. The cash-settlement survey should include a minimum of four independent entities if such sources do not take positions in the commodity (e.g., if the survey list is comprised exclusively of brokers) or at least eight independent entities if such sources trade for their own accounts (e.g., if the survey list is comprised of dealers or merchants).

(iii) The cash-settlement calculation should involve computational procedures that eliminate or reduce the impact of potentially unrepresentative data.

(iv) The cash settlement price should be an accurate and reliable indicator of prices in the underlying cash market. The cash settlement price also should be acceptable to commercial users of the commodity contract. The registered entity should fully document that the settlement price is accurate, reliable, highly regarded by industry/market agents, and fully reflects the economic and commercial conditions of the relevant designated contract market.

(v) To the extent possible, the cash settlement price should be based on cash price series that are publicly available and available on a timely basis for purposes of calculating the cash settlement price at the expiration of a commodity contract. A designated contract market should make the final cash settlement price and any other supporting information that is appropriate for release to the public, available to the public when cash settlement is accomplished by the derivatives clearing organization. If the cash settlement price is based on cash prices that are obtained from non-public sources (e.g., cash market surveys conducted by the designated contract market or by third parties on behalf of the designated contract market), a designated contract market should make available to the public as soon as possible after a contract month's expiration the final cash settlement price as well as any other supporting information that is appropriate or feasible to make available to the public.

(4) **Contract Terms and Conditions Requirements for Futures Contracts Settled by Cash Settlement**

(i) An acceptable specification of the terms and conditions of a cash-settled commodity contract will also set forth the trading months, last trading day, contract size, minimum price change (tick size) and daily price limits, if any.

(A) *Commodity Characteristics*: The terms and conditions of a commodity contract should describe the commodity underlying the contract.

(B) *Contract Size and Trading Unit*: An acceptable specification of the trading unit would be a contract size that is consistent with customary transactions in the cash market. A designated contract market may opt to set the contract size smaller than that of standard cash market transactions.

(C) *Cash Settlement Procedure*: The cash settlement price should be reliable, acceptable, publicly available, and reported in a timely manner as described in paragraphs (c)(3)(iv) and (c)(3)(v) of this appendix C.

(D) *Pricing Basis and Minimum Price Fluctuation (Minimum Tick)*: The minimum price increment (tick) should be set a level that is equal to, or less than, the minimum price increment commonly observed in cash market transactions for the underlying commodity. Specifying a futures' minimum tick that is greater than the minimum price increment in the cash market can undermine the risk management utility of the futures contract by preventing hedgers from efficiently establishing and liquidating futures positions that are used to hedge anticipated cash market transactions or cash market positions.

(E) *Maximum Price Fluctuation Limits*: Designated contract markets may adopt price limits to: (1) Reduce or constrain price movements in a trading day that may not be reflective of true market conditions but might be caused by traders overreacting to news; (2) Allow additional time for the collection of margins in times of large price movements; and (3) Provide a "cooling-off" period for futures market participants to respond to bona fide changes in market supply and demand fundamentals that would lead to

large cash and futures price changes. If price-limit provisions are adopted, the limits should be set at levels that are not overly restrictive in relation to price movements in the cash market for the commodity underlying the futures contract. For broad-based stock index futures contracts, rules should be adopted that coordinate with New York Stock Exchange ("NYSE") declared Circuit Breaker Trading Halts and would recommence trading in the futures contract only after trading in the majority of the stocks underlying the index has recommenced.

(F) *Last Trading Day*: Specification of the last trading day for expiring contracts should be established such that it occurs before publication of the underlying third-party price index or determination of the final settlement price. If the designated contract market chooses to allow trading to occur through the determination of the final settlement price, then the designated contract market should show that futures trading would not distort the final settlement price calculation.

(G) *Trading Months*: Trading months should be established based on the risk management needs of commercial entities as well as the availability of price and other data needed to calculate the cash settlement price in the specified months. Specification of the last trading day should take into consideration whether the volume of transactions underlying the cash settlement price would be unduly limited by occurrence of holidays or traditional holiday periods in the cash market. Moreover, a contract should not be listed past the date for which the designated contract market has access to use a proprietary price index for cash settlement.

(H) *Speculative Limits*: Specific rules and policies for speculative position limits are set forth in the part 151 of the Commission's regulations.

(I) *Reportable Levels*: Refer to § 15.03 of the Commission's regulations.

(J) *Trading Hours*: Should be set by the designated contract market to delineate each trading day.

(d) *Options on a Futures Contract*. (1) The Commission's experience with the oversight of trading in futures option contracts indicates that most of the terms and conditions associated with such trading do not raise any regulatory concerns or issues. The Commission has found that the following terms do not affect an option contract's susceptible to manipulation or its utility for risk management. Thus, the Commission believes that, in most cases, any specification of the following terms would be acceptable; the only requirement is that such terms be specified in an automatic and objective manner in the option contract's rules:

- Exercise method;
- Exercise procedure (if positions in the underlying futures contract are established via book entry);
- Strike price listing provisions, including provisions for listing strike prices on a discretionary basis;
- Strike price intervals;
- Automatic exercise provisions;
- Contract size (unless not set equal to the size of the underlying futures contract); and

○ Option minimum tick should be equal to or smaller than that of the underlying futures contract.

(2) *Option Expiration & Last Trading Day*. For options on futures contracts, specification of expiration dates should consider the relationship of the option expiration date to the delivery period for the underlying futures contract. In particular, an assessment should be made of liquidity in the underlying futures market to assure that any futures contracts acquired through exercise can be liquidated without adversely affecting the orderly liquidation of futures positions or increasing the underlying futures contract's susceptibility to manipulation. When the underlying futures contract exhibits a very low trading activity during an expiring delivery month's final trading days or has a greater risk of price manipulation than other contracts, the last trading day and expiration day of the option should occur prior to the delivery period or the settlement date of the underlying future. For example, the last trading day and option expiration day might appropriately be established prior to first delivery notice day for option contracts with underlying futures contracts that have very limited deliverable supplies. Similarly, if the futures contract underlying an option contract is cash settled using cash prices from a very limited number of underlying cash market transactions, the last trading and option expiration days for the option contract might appropriately be established prior to the last trading day for the futures contract.

(3) *Speculative Limits*. In cases where the terms of an underlying futures contract specify a spot-month speculative position limit and the option contract expires during, or at the close of, the futures contract's delivery period, the option contract should include a spot-month speculative position limit provision that requires traders to combine their futures and option position and be subject to the limit established for the futures contract. Specific rules and policies for speculative position limits are set forth in part 151 of the Commission's regulations.

(4) *Options on Physicals Contracts*.

(i) Under the Commission's regulations, the term "option on physicals" refers to option contracts that do not provide for exercise into an underlying futures contract. Upon exercise, options on physicals can be settled via physical delivery of the underlying commodity or by a cash payment. Thus, options on physicals raise many of the same issues associated with trading in futures contracts regarding adequacy of deliverable supplies or acceptability of the cash settlement price series. In this regard, an option that is cash settled based on the settlement price of a futures contract would be considered an "option on physicals" and the futures settlement price would be considered the cash price series.

(ii) In view of the above, acceptable practices for the terms and conditions of options on physicals contracts include, as appropriate, those practices set forth above for physical-delivery or cash-settled futures contracts plus the practices set forth for options on futures contracts.

(e) *Security Futures Products*. (1) The listing of security futures products are



governed by the special requirements of part 41 of the Commission's regulations. A designated contract market should follow the appropriate guidance regarding physically delivered security futures products that are settled through physical delivery or cash settlement.

(f) *Non-Price Based Futures Contracts.* (1) Non-price based contracts are typically construed as binary options, but also may be designed to function similar to traditional futures or option contracts.

(2) Where the contract is settled to a third party cash-settlement series, the designated contract market should consider the nature and sources of the data comprising the cash-settlement calculation, the computational procedures, and the mechanisms in place to ensure the accuracy and reliability of the index value. The evaluation also considers the extent to which the third party has, or will adopt, safeguards against unauthorized or premature release of the index value itself or any key data used in deriving the index value.

(3) The designated contract market should follow the guidance in paragraph (c)(4) (Contract Terms and Conditions Requirements for Futures Contracts Settled by Cash Settlement) of this appendix C to meet compliance.

(g) *Swap Contracts.* (1) In general, swap contracts are an agreement to exchange a series of cash flows over a period of time based on reference price indices. When listing a swap for trading, a swap execution facility or designated contract market must determine that the reference price indices used for its contracts are not readily susceptible to manipulation. Accordingly, careful consideration should be given to the potential for manipulation or distortion of the cash settlement price, as well as the reliability of that price as an indicator of cash market values. Appropriate consideration also should be given to the commercial acceptability, public availability, and timeliness of the price series that is used to calculate the cash settlement price. Documentation demonstrating that the settlement price index is a reliable indicator of market values and conditions and is highly regarded by industry/market agents should be provided. Such documentation may take on various forms, including carefully documented interviews with principal market trading agents, pricing experts, marketing agents, etc. Appropriate consideration also should be given to the commercial acceptability, public availability, and timeliness of the price series that is used to calculate the cash flows of the swap.

(i) Where an independent, private-sector third party calculates the referenced price index, the designated contract market should verify that the third party utilizes business practices that minimize the opportunity or incentive to manipulate the cash-settlement price series. Such safeguards may include lock-downs, prohibitions against derivatives trading by employees, or public dissemination of the names of sources and the price quotes they provide. Because a cash-settled contract may create an incentive to manipulate or artificially influence the underlying market from which the cash-settlement price is derived or to exert undue influence on the cash-settlement

computation in order to profit on a futures position in that commodity, a designated contract market should, whenever practicable, enter into an information-sharing agreement with the third-party provider which would enable the designated contract market to better detect and prevent manipulative behavior.

(ii) Where a designated contract market itself generates the cash settlement price series, the designated contract market should establish calculation procedures that safeguard against potential attempts to artificially influence the price. For example, if the cash settlement price is derived by the designated contract market based on a survey of cash market sources, the designated contract market should maintain a list of such entities which all should be reputable sources with knowledge of the cash market. In addition, the sample of sources polled should be representative of the cash market, and the poll should be conducted at a time when trading in the cash market is active. The cash-settlement survey should include a minimum of four independent entities if such sources do not take positions in the commodity (e.g., if the survey list is comprised exclusively of brokers) or eight independent entities if such sources trade for their own accounts (e.g., if the survey list is comprised of dealers or merchants).

(iii) The cash-settlement calculation should involve appropriate computational procedures that eliminate or reduce the impact of potentially unrepresentative data.

(2) *Speculative Limits:* Specific rules and policies for speculative position limits are set forth in part 151 of the Commission's regulations.

(3) *Intraday Market Restrictions:* Designated contract markets or swap execution facilities must have in place intraday market restrictions that pause or halt trading in the event of extraordinary price moves that may result in distorted prices. Such restrictions need to be coordinated with other markets that may be a proxy or a substitute for the contracts traded on their facility. For example, coordination with NYSE rule 80.B Circuit Breaker Trading Halts. The designated contract market or swap execution facility must adopt rules to specifically address who is authorized to declare an emergency; how the designated contract market or swap execution facility will notify the Commission of its decision that an emergency exists; how it will address conflicts of interest in the exercise of emergency authority; and how it will coordinate trading halts with markets that trade the underlying price reference index or product.

(4) *Settlement Method.* The designated contract market or swap execution facility should follow the guidance in paragraph (c)(4) (Contract Terms and Conditions Requirements for Futures Contracts Settled by Cash Settlement) of this appendix C to meet compliance, or paragraph (b)(2) (Contract Terms and Conditions Requirements for Futures Contracts Settled by Physical Delivery) of this appendix C, as appropriate.

By the Commission.

Dated: December 1, 2010.

**David A. Stawick,**  
*Secretary.*

### **Appendices to Core Principles and Other Requirements for Designated Contract Markets—Commission Voting Summary and Statements of Commissioners**

**Note:** The following appendices will not appear in the Code of Federal Regulations

#### **Appendix 1—Commission Voting Summary**

On this matter, Chairman Gensler and Commissioners Dunn and Chilton voted in the affirmative; Commissioners Sommers and O'Malia voted in the negative.

#### **Appendix 2—Statements of Commissioners**

##### *Statement of Chairman Gary Gensler*

I support the proposed rulemaking to update our rules and guidance with regard to designated contract markets (DCMs). The Dodd-Frank Act updated the statutory language for core principles for contract markets, increasing the number to 23 and modifying existing core principles. Thus, it is important to update our rules and guidance to reflect those changes. Further, the Dodd-Frank Act allows DCMs to—for the first time—offer swaps in addition to futures and commodity options, and this proposal addresses that broader scope. I believe it is also important to update the rules and guidance for DCMs in light of the fact that we will be promulgating rules and guidance for swap execution facilities, and many of the core principles are similar. This rule will help to promote transparency and market integrity.

##### *Dissent of Commissioner Jill E. Sommers and Commissioner Scott D. O'Malia*

We respectfully dissent from the action taken today by the Commission to issue proposed regulations relating to "Core Principle and Other Requirements for Designated Contract Markets" (DCMs). While we each dissent for a number of reasons, we join in writing to express our disagreement with the Commission's narrow interpretation of Core Principle 9—*Execution of Transactions*, and request comment on the implications of such a narrow interpretation of Core Principle 9 for markets and market participants.

In relevant part, Core Principle 9 states: "The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market of the board of trade." Core Principle 9 does not say that every contract listed for trading on the board of trade must trade in the centralized market. Nor does it require that every contract listed for trading serve a price discovery function. Rather, it requires a mechanism for protecting the price discovery function for those contracts that do trade in the centralized market. With these proposed regulations, the Commission is interpreting

Core Principle 9 in a way that does not comport with the plain language of the statute.

Over the past decade, a long list of non-standardized, illiquid contracts in the energy sphere have been executed off-exchange and cleared on-exchange through the exchange of futures for swaps (EFS) mechanism. The availability of clearing for these contracts added a level of safety, soundness and transparency to the marketplace that did not exist before. If the Commission had not permitted these contracts to be listed for clearing through the EFS process it is highly doubtful that the level of clearing that exists today for these contracts would have been achieved, and highly likely that this activity would have remained opaque to market participants and regulators. Congress was aware of this specialized marketplace when it amended Core Principle 9. If Congress had

intended to outlaw this activity it could have done so by explicitly requiring all DCM contracts to trade in the centralized market. It did not do so. In fact, Core Principle 9 explicitly allows boards of trade to authorize certain types of contracts that have traditionally been traded off the centralized market, including EFS.

Finally, the full ramifications of the Commission's overly-restrictive reading of Core Principle 9 are not yet known, but are likely to be of great consequence to many market participants. Clearing helps mitigate risk, and the movement of illiquid contracts into a cleared environment was a positive development for our markets and market participants. Clearing contracts listed on a DCM also permits market participants to take advantage of certain efficiencies, like portfolio margining. Now, hundreds of contracts that are listed for trading on DCMs

and cleared likely will no longer enjoy that status. The assumption appears to be that these contracts will simply be listed for trading on a swap execution facility (SEF) and cleared, without any disruption to markets or market participants. We are not willing to make such a bold assumption, especially when the Commission has not yet proposed regulations relating to listing and trading requirements for SEFs.

We would have preferred that the proposed regulations preserve the functioning of this specialized marketplace; a marketplace that has not adversely affected price discovery for any contract currently traded in the centralized market.

[FR Doc. 2010-31458 Filed 12-21-10; 8:45 am]

**BILLING CODE 6351-01-P**