

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 1 and 38

Execution of Transactions: Regulation 1.38 and Guidance  
on Core  
Principle 9

AGENCY: Commodity Futures Trading Commission.

ACTION: Proposed rules.

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SUMMARY: The Commodity Futures Trading Commission ('`Commission'' or ``CFTC'') is proposing a number of amendments to its rules concerning trading off the centralized market, including the addition of guidance on contract market block trading rules. The Commission is proposing these rule amendments and requesting comment as part of its continuing efforts to update its regulations in light of the Commodity Futures Modernization Act of 2000 ('`CFMA'').

DATES: Comments must be received by August 30, 2004.

ADDRESSES: Comments should be sent to the Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581, attention: Office of the Secretariat. Comments may be sent by facsimile transmission to 202-418-5521 or, by e-mail to [secretary@cftc.gov](mailto:secretary@cftc.gov). Reference should be made to ``Proposed Rules for

Trading Off the Centralized Market.'' Comments may also be submitted by connecting to the Federal eRulemaking Portal at

<http://frwebgate.access.gpo.gov/cgi-bin/leaving.cgi?from=leavingFR.html&log=linklog&to=http://www.regulations.gov>

and following comment submission instructions.

FOR FURTHER INFORMATION CONTACT: Riva Spear Adriance, Associate Deputy Director for Market Review, Division of Market Oversight, Commodity Futures Trading Commission, Three Lafayette Center, 1155 21st Street, NW., Washington, DC 20581. Telephone 202-418-5494; e-mail [radriance@cftc.gov](mailto:radriance@cftc.gov).

#### SUPPLEMENTARY INFORMATION:

##### I. Background

Commission Regulation Section 1.38 (17 CFR 1.38) 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 designated contract market ('`DCM'') should be executed by open and competitive methods. This ``open and competitive'' requirement is modified by a proviso that allows transactions to be executed in a ``non-competitive'' manner if the transaction is in compliance with DCM rules specifically providing for the non-competitive execution of such transactions, and such rules have been submitted to, and approved by, the Commission.

Since Regulation 1.38 was promulgated,\1\ the CFMA was enacted.\2\ Federal regulation of commodity futures and option markets was significantly changed by the CFMA, which replaced ``one-size-fits-all''

regulation with broad, flexible core principles.\3\ At the same time, the CFMA modified Section 3 of the Act, such that the purpose of the Act is now, among other things, ``to deter and prevent price manipulation or any other disruptions to market integrity; to ensure the financial integrity of all transactions subject to this Act and the avoidance of systemic risk; to protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets \* \* \*'' \4\ The CFMA also specifically expanded the types of transactions that could lawfully be executed off the centralized market. Specifically, the CFMA permits DCMs to establish trading rules that: (1) Authorize the exchange of futures for swaps; or (2) allow 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.\5\

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\1\ Regulation 1.38 was originally adopted in 1953 by the Commodity Exchange Authority, the predecessor of the Commission. See 18 FR 176 (Jan. 19, 1953). For subsequent amendments, see 31 FR 5054 (Mar. 29, 1966), 41 FR 3191 (Jan. 21, 1976, eff. Feb. 20, 1976), and 46 FR 54500 (Nov. 3, 1981, eff. Dec. 3, 1981).

\2\ Pub. L. 106-554, 114 Stat. 2763 (2000). Under the CFMA, such

rules may be effected by the certification procedures set forth in section 5c(c) of the Act and 40.6 of the Commission's regulations.

\3\ The CFMA was intended, in part, ``to promote innovation for futures and derivatives.'' See Sec. 2 of the CFMA. It was also intended ``to reduce systemic risk,'' and ``to transform the role of the [Commission] to oversight of the futures markets.'' Id.

\4\ 7 U.S.C. 5 (2000).

\5\ See section 7(b)(3) of the Act.

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The Commission promulgated regulations implementing provisions of the CFMA relating to trading facilities in 2001, which established procedures relating to trading facilities, interpreted certain of the CFMA's provisions and provided guidance on compliance with various of its requirements.\6\ Later, the Commission promulgated amendments to those regulations in response to issues that had arisen in administering the rules, noting that the Commission would consider ``additional amendments to the rules implementing the CFMA based upon further administrative experience.'' \7\ Consistent with that rationale, the Commission now proposes to amend: (i) Commission Regulation 1.38; and (ii) Commission guidance concerning Core Principle 9 as it relates to Commission Regulation 1.38, to include changes that the Commission believes necessary based upon its

experience  
administering those provisions.\8\  
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\6\ See 66 FR 14262 (Mar. 9, 2001) and 66 FR 42256  
(Aug. 10,  
2001).

\7\ See 67 FR 20702 (Apr. 26, 2002) and 67 FR 62873  
(Oct. 9,  
2002).

\8\ Core Principle 9 (7 U.S.C. 5(d)(9) (Execution  
of  
transactions) states that ``The board of trade shall  
provide a  
competitive, open, and efficient market and mechanism  
for executing  
transactions.''  
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## II. Discussion of the Proposed Rule Amendment and Guidance

### A. Proposed Amendments to Regulation 1.38

At the time that the Commission promulgated its  
first rules  
implementing the CFMA, it retained Regulation 1.38 as  
applicable to  
DCMs. The Commission now proposes to rearrange and  
amend Regulation  
1.38 in light of further consideration of the  
implications of the CFMA  
and administrative experience. The proposed amendments  
simplify the  
text and update the requirements of Regulation 1.38,  
including language  
specifically expanding types of transactions that may  
lawfully be  
executed off of a DCM's centralized market in  
accordance with the CFMA.

For instance, the Act, as amended by the CFMA,  
specifically allows  
the exchange of futures for swaps,\9\ and since the

CFMA was enacted,  
several DCMs have adopted rules that allow the exchange  
of futures for  
swaps,\10\ or for another derivatives position.\11\ The  
Commission is  
proposing, therefore, to update the language of  
Regulation 1.38 by  
substituting the phrase ``the exchange of futures for a  
commodity or  
for a derivatives position'' for the phrase ``the  
exchange of futures  
for cash commodities or the exchange of futures in  
connection with cash  
commodity transactions.'' \12\ Furthermore, as the CFMA  
implemented the  
rule certification procedures of Section 5c(c)(1) of  
the Act,\13\ the  
proposed changes to Regulation 1.38 would add  
transactions carried out  
pursuant to certified rules to the transactions that  
are allowed to be  
executed away from the centralized market.\14\  
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\9\ See section 5(b)(3) of the Act (7 U.S.C.  
7(b)(3)).

\10\ See, e.g. (Chicago Board of Trade (``CBOT'')  
Rule 444.04,  
INET Futures Exchange, LLC (``INET'') Rule 606,  
Merchants Exchange  
(``ME'') Rule 418(b), New York Board of Trade  
(``NYBOT'') Rule 4.13,  
New York Mercantile Exchange, Inc. (``NYMEX'') Rule  
6.21A and U.S.  
Futures Exchange, LLC (``USFE'') Rule 417.

\11\ See, e.g., (i) rules allowing the exchange of  
futures for  
options NQLX LLC Futures Exchange (``NQLX'') Rule 420  
(Exchange for  
Physical Trades) and USFE Rule 418 (Volatility  
(``VOLA'') Trading  
Facility--Exchange of Futures for Options)); (ii) rules  
allowing for  
the exchange of futures over-the-counter (``OTC'')

derivatives  
(Kansas City Board of Trade ('`KCBT'`) Rule 1129  
(Exchange For Risk  
(``EFR'`) Transactions) and CBOT Rule 444.06 (Exchange  
of Futures  
for, or in Connection with, OTC Agricultural Option  
Transactions));  
and (iii) rules allowing the exchange of futures for  
any derivative,  
by-product or related product (NYMEX Rule 6.21  
(Exchange of Futures  
for, or in Connection with, Product).

\12\ The Commission observes that although this  
language retains  
the phrase ``futures for [a] commodity,' it does not  
retain the  
phrase ``in connection with [a] commodity.' The  
Commission also  
notes that the phrase ``exchange of futures for a  
commodity or for a  
derivatives position' does not include elements of  
these exchanges.  
Instead, essential elements of bona fide exchange of  
futures trades  
have been provided in the guidance to Core Principle 9  
below. See  
infra section III.B.4. See also proposed Appendix  
B(9)(b)(2)(iii) to  
Part 38.

\13\ Under section 5c(c)(1) of the Act as amended  
by the CFMA,  
DCMs are allowed to implement any new rule or rule  
amendment, except  
for material changes to enumerated agricultural  
products, by  
providing a written certification to the Commission  
that the new  
rule, or rule amendment complies with this Act and the  
Commission's  
regulations.

\14\ See proposed Regulation 1.38(b). Current  
Regulation 1.38  
limits transactions that can be executed away from the  
centralized  
market to those transactions carried out pursuant to

rules approved  
by the Commission.

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## B. Amendments to Guidance on Core Principle 9

The Commission proposes to rearrange and amend its guidance for compliance with Core Principle 9 in light of consideration of the implications of the CFMA and further administrative experience. The proposed guidance separates guidance provided for DCM transactions on the centralized market from guidance provided for DCM transactions off the centralized market. The current proposal also provides more detailed information concerning acceptable practices regarding the execution of transactions off the centralized market. Specifically, given the Commission's growing experience with markets in which block trades are permitted, this release proposes amending the guidance to provide more detail regarding acceptable block trading rules. Additionally, the proposed guidance describes under what circumstances the exchange rules can permit arm's length block trades between affiliated parties.

### 1. General Guidance

Current Commission Regulation 1.38(b) provides that every person handling, executing, clearing, or carrying trades, transactions or positions that are not competitively executed, must identify and mark by appropriate symbol or designation all such transactions or contracts and all associated orders, records, and memoranda. As well as updating

the language of Regulation 1.38(b), the proposed amendments add this requirement to the guidance under Core Principle 9, to provide consolidated guidance regarding recordkeeping practices pertaining to transactions off the centralized market.

The guidance for Core Principle 9 also addresses the testing and review of automated trading systems. Currently, the guidance states that acceptable testing of automated systems should be ``objective,'' and calls for the provision of ``objective'' test results.<sup>15</sup> The proposed guidance would also call for the provision to the Commission of test results of any ``non-objective'' testing carried out by or for a DCM (i.e., in-house reviews) regarding the system functioning capacity or security of any automated trading systems. Although the results of ``non-objective'' testing would be of more limited use, the Commission believes that test results of any ``non-objective'' testing carried out by or for the DCM should also be provided to the Commission.

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<sup>15</sup> Appendix B (a)(1)(iii) and (b)(1)(ii)(B), both to Part 38.

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## 2. Block Trade Rules

The Commission is proposing to provide guidance to DCMs with respect to their rules for block transactions. The guidance provides block trade standards that would be acceptable to the Commission. These

acceptable block trade standards adopt elements of block trade rules previously approved by the Commission. For example, under proposed Appendix B(9)(b)(2)(ii)(B) to Part 38, block trade parties generally are required to be eligible contract participants ('`ECPs''), although commodity trading advisors ('`CTA'') and investment advisors having over \$25 million in assets under management \16\ are allowed to carry out

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block trades for non-ECP customers. The Commission originally approved a comparable requirement in CX and Chicago Mercantile Exchange ('`CME'') block-trading rules.\17\  
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\16\ Including foreign persons performing equivalent roles.

\17\ See CX Rule 305-A and CME Rule 523. CX's and CME's original block trade rules both called for the CTA or investment advisor to have \$50 million in assets under management. Subsequently, CME submitted a rule change that lowered the amount of assets required to be under management to \$25 million for CTAs and investment advisors. This requirement is currently found in CME, CBOE Futures Exchange ('`CFE''), CBOT, NYBOT, OneChicago Futures Exchange ('`OCX'') and USFE block trading rules (Rules: 523(I), 415(a)(ii), 331.05(c), 4.31, 417(ii) and 415(b); all respectively). Although BTEX trading operations have been suspended, its block

trading rules  
also included this requirement. This requirement is not  
included in  
NQLX and INET block trading rules (Rules 419(a) and  
704(a),  
respectively), as those rules limit block trades to  
members and  
wholesale customers.

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Under proposed Appendix B(9)(b)(2)(ii)(A) to Part  
38, a DCM must  
determine a minimum size for block transactions. An  
acceptable minimum  
size would be no smaller than the customary size of  
large transactions  
in any relevant markets.\18\ Aggregation of orders for  
different  
accounts in order to satisfy the minimum size  
requirement would be  
prohibited except in appropriate circumstances.\19\  
Under the proposal,  
the aggregation of orders would be acceptable only if  
done by certain  
registered persons having discretion to trade customer  
accounts.\20\  
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\18\ See proposed Appendix B(9)(b)(2)(ii)(A) to  
Part 38.

\19\ See proposed Appendix B(9)(b)(2)(ii)(C) to  
Part 38.

\20\ Appropriate registered persons include a CTA  
registered  
pursuant to section 4m of the Act, or a principal  
thereof, including  
any investment advisor who satisfies the criteria of  
Sec.  
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,  
where such CTA, investment advisor or foreign person

has more than \$25,000,000 in total assets under management. This requirement is currently found in CME, CBOT, CFE, NYBOT, OCX and USFE block trading rules ((Rules: 523(I), 331.05(c), 415(a)(ii), 4.31(a)(i), 417(ii) and 415(f); all respectively)). BTEX and CX block trading rules also included this requirement. INET Rule 704(c) and NQLX Rule 419(c)(2) each include a similar rule that allows aggregation only for advisers with discretion over multiple discretionary accounts of appropriate customers ('`wholesale customers'' or ``block trader'' respectively).

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A majority of exchanges that permit block trading prohibit persons from effecting block trades on behalf of customers unless the person receives a customer's explicit instruction or prior consent to do so.\21\ The proposed guidance incorporates this prohibition as an acceptable practice.

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\21\ See CME Rule 526(C), CFE Rule 415(a)(i), CBOT Rule 331.05(a), NYBOT Rule 4.31(a)(ii)(A), OCX Rule 417(a)(i), and USFE Rule 415(c). BTEX's block trading rules also tracked this requirement.

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Under the proposed guidance, acceptable block trade rules would

require parties to, and members facilitating, a block trade to keep appropriate records.\22\ Appropriate block trade records would comply with the requirements of Core Principle 10 and Core Principle 17. Records kept in accordance with the requirements of Statement No. 133 ('`Accounting for Derivative Instruments and Hedging Activities''), issued by the Financial Accounting Standards Board ('`FASB''), would be satisfactory.\23\ Acceptable block trade rules would require that block orders be recorded by the member and time-stamped with both the time the order was received by the member and the time the order was executed. This guidance is based on CME and USFE block trading rules that have been approved by the Commission.\24\ When requested during an investigation, parties to, and members facilitating, a block trade should provide records to document that the block trade is executed in accordance with contract market rules.

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\22\ Proposed Appendix B(9)(b)(2)(ii)(E) to Part 38.

\23\ FASB Statement No. 133 provides guidance on the use of accounting for corporate hedge activity involving derivative transactions. The statement includes guidance on documenting the hedging relationship.

\24\ Rules 536.A and 415(c), respectively. BTEX block trading rules also tracked this requirement.

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Proposed Appendix B(9)(b)(2)(ii)(F) to Part 38 requires reporting of the block trade to the DCM within a reasonable period of time once the transaction is executed. Reporting periods previously approved by the Commission, when executed under comparable circumstances, would be considered reasonable time periods for reporting a block transaction to the DCM.\25\  
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\25\ Currently, NYBOT block trading rule requires reporting of block trades within two minutes. See Rule 4.31(a)(v). CBOT, CME (generally), and INET rules require reporting of a block trade within five minutes, although CME allows 15 minutes for reporting block trades in Eurodollars. See Rules 331.05(d), 526.F., and 704(e)(iv), respectively. NQLX rules require reporting of a block trade to the DCM within eight minutes. See Rule 419(g)(2). The OCX rule, in comparison, requires that parties report the block trade ``without delay'' and also prohibits carrying out offsetting trades until after the block trade has been reported to and disseminated by the exchange. See Rules 417(e) and (f). Finally, the USFE rule requires that the block trade buyer enter the details of the block trade into the USFE trading system immediately upon agreement to enter into the trade, to which the seller must respond within 15 minutes confirming the block transaction on the electronic trading system. See Rule 415(h). By the seller's confirmation

of the block transaction on the trading system, USFE is immediately, and automatically, notified of the block trade.

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The proposed guidance also identifies publication of block trade details by DCMs immediately upon receipt of block trade reports as an acceptable practice.\26\ This proposed acceptable practice would also require the DCM to identify block trades on its trade register.\27\  
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\26\ Proposed Appendix B(9)(b)(2)(ii)(G) to Part 38. See also, CME, CFE, CBOT, INET, NYBOT, OCX and USFE block trading rules. This is also an element of compliance with Designation Criterion 3 (Fair and Equitable Trading) and Core Principle 8 (Daily Publication of Trading Information).

\27\ Proposed Appendix B(9)(b)(2)(ii)(H) to Part 38.  
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Under the proposed guidance, acceptable block trade rules would require that the block trades be at a price that is fair and reasonable.\28\ Consideration of whether a block transaction price is fair and reasonable could take into account: (i) The size of the block; and (ii) the price and size of other trades in any relevant markets at the applicable time, or the circumstances of the market or the parties to the block trade.\29\ Relevant markets could include,

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limitation, the DCM itself, the underlying cash markets  
and/or other  
related futures markets.

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\28\ Proposed Appendix B(9)(b)(2)(ii)(I) to Part  
38.

\29\ A similar ``fair and reasonable'' price  
parameter is found  
in Commission memoranda on block trading, in versions  
of Part 38  
regulations adopted prior to the passage of the CFMA  
(see 65 FR  
77962, see also 65 FR 82272 (withdrawing regulations  
due to  
enactment of the CFMA)) as well as current CBOT, CFE,  
CME, and NYBOT  
block trading rules, Rules 331.05(b), 415(c), 526.D.,  
4.31(a)(iii),  
respectively.

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If a DCM rule requiring a fair and reasonable price  
included the  
``circumstances'' of the parties or of the market  
within its  
parameters, a block trade participant could execute a  
block transaction  
at a price that was away from the market provided that  
the participant  
retained documentation to demonstrate that the price  
was indeed fair  
and reasonable under the participant's legitimate  
trading objectives or  
the market's particular circumstances. Analysis of  
whether a block  
trade price outside the bid/ask spread or prices of  
contemporaneous  
transactions in the futures market is fair and  
reasonable, however,  
should consider how the block trade price reflects  
commercial

realities. A price that is away from any market may raise suspicion concerning the legitimacy of the trade.

As a result, inclusion of the ``circumstances'' of the parties or of the market within the parameters of the fair and reasonable price guidance provides flexibility to market participants while allowing the DCM to later review the price of the block trade, as the exchange would have the ability to obtain trade participant documentation if necessary.

### 3. Block Trades Between Affiliated Parties

Under the proposed guidance, acceptable block trade rules would

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require that block trades be arm's length transactions.\30\ For exchanges that desire to allow block trading between affiliated parties, however, the proposed Appendix B(9)(b)(2)(ii)(J) to Part 38, would also provide guidance on acceptable rules for affiliate block trades, which when carried out consistent with the guidance would be presumed to be arm's length transactions. Specifically, the proposed guidance provides that block transactions between parties that have an arm's length organizational structure will be presumed to be at arm's length. Under the guidance, an ``arm's length organizational structure'' is one in which the counterparties (whether affiliated or not), each have a separate account controller, with its own responsibility to review and evaluate the terms and conditions and the potential risks and benefits of prospective

transactions.  
Alternatively, block transactions between affiliated parties will be presumed to be at arm's length if they are executed during trading hours and are carried out at an arm's length price, as provided by the guidance.\31\  
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\30\ Proposed Appendix B(9)(b)(2)(ii)(J) to Part 38.

\31\ See proposed Appendix B(9)(b)(2)(ii)(J) to Part 38.  
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In addition to the requirements previously discussed, acceptable DCM rules for affiliate block trades would require: (i) Execution during the contract's trading hours; (ii) transaction prices that fall within the bid/ask spread on electronic trading systems or prices of contemporaneous related trading floor transactions, although if the contract does not have a bid/ask spread or any floor transactions at the time of the block transaction, then the contemporaneous bid/ask spread or price of transactions on related futures or cash markets could be used; and (iii) identification of the trade on the order ticket and to the DCM as a trade that was between affiliated parties.

The proposed price parameters for affiliate block trades (a prevailing bid-ask spread or price of contemporaneous related floor transactions) would be a narrower subset of the fair and reasonable price parameter proposed for block trades between

parties that are not affiliated.\32\ Block transactions between affiliated parties raise concerns that such block trades may be susceptible to abuse. Under the Commission's proposal, only block trade prices between affiliated parties that fall within a price parameter using concrete prices (contemporaneous bid-ask spread or prices in contemporaneous market(s)) would be assumed to be at arm's length. Such a pricing parameter provides an objective method for determining whether the price of an affiliated party block trade was fairly negotiated and absent any pricing abuse, and, consequently, warranting a presumption that the block trade was carried out at arm's length.

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\32\ See proposed Appendices B(9)(b)(2)(ii)(J)(2) and B(9)(b)(2)(ii)(I) to Part 38.

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The Commission expects that the proposed guidance will benefit DCMs that are interested in allowing affiliate block transactions, as well as participants that desire to take advantage of such rules as the guidance provides participants with alternative means to comply with the requirement that block transactions be carried out at arm's length.\33\ Affiliate block trades that are not carried out according to this guidance could be subject to greater scrutiny. Such scrutiny would not be based on a presumption of illegitimacy, but on lack of

information about the trade. Firms that execute affiliate block transactions outside of the guidance, therefore, should preserve records (in addition to those they are required to keep in any event) in order to answer any questions regarding the trade.

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\33\ See proposed Appendix B(9)(b)(2)(ii)(J) to Part 38.

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#### 4. Exchange of Futures for a Commodity or for a Derivatives Position

The essential elements of bona fide exchange of futures trades have been provided in the guidance to Core Principle 9 below.\34\ The elements proposed are found in current contract market EFP, EFS, EFR and EFO rules and are based on the essential elements for bona fide EFPs detailed in the 1987 EFP Report prepared by the Commission's then Division of Trading and Markets.\35\ The elements include separate but integrally related transactions, an actual transfer of ownership of the commodity or derivatives position, and both legs transacted between the same two parties. The Commission notes that the determination whether an actual transfer of ownership has occurred will depend upon the facts and circumstances of each transaction. In each instance where an exchange of futures for a commodity or for a derivatives position is linked to another offsetting transaction, the particular facts and circumstances may warrant a determination that there was not an actual

ownership transfer of each leg of the commodity or derivatives position.

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\34\ See proposed Appendix B(9)(b)(2)(iii) to Part 38.

\35\ See generally, Division of Trading and Markets, Report on Exchanges of Futures for Physicals (1987). See also, CBOT Rules 444.01, 444.01B, 444.04 and 444.06; CBOE Rule 414; CME Rule 538; INET Rules 705 and 706; KCBT Rules 1128.00, 1128.02, 1129.00, and 1129.02; ME Rule 418; MGE Rule 719; NQLX Rule 420; NYBOT Rules 4.12 and 4.13, NYMEX Rules 6.21, 6.21A and 6.21E, and OCX Rule 416.

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#### IV. Related Matters

##### A. Regulatory Flexibility Act

The Regulatory Flexibility Act \36\ requires federal agencies, in proposing rules, to consider the impact of those rules on small businesses. The rule amendments adopted herein will affect DCMs, FCMs, CTAs and large traders. 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.\37\ The Commission has previously determined that DCMs,\38\ registered FCMs,\39\ and large traders \40\ are not small entities for the purpose of the RFA. With respect to CTAs, the

Commission has determined to evaluate within the context of a particular rule proposal whether CTAs would be considered ``small entities'' for purposes of the Regulatory Flexibility Act and, if so, to analyze the economic impact on the affected entities of any such rule at that time.\41\ The Commission believes that the instant proposed rules will not place any new burdens on entities that would be affected hereunder, and the Commission does not expect the proposed amendments to cause persons to change their current methods of doing business in most cases. This is because requirements under the instant proposal, if adopted, would be similar to most existing DCM requirements.

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- \36\ 5 U.S.C. 601 et seq.
- \37\ 47 FR 18618-21 (Apr. 30, 1982).
- \38\ Id. at 18618-19.
- \39\ Id. at 18619-20.
- \40\ Id. at 18620.
- \41\ 47 FR at 18618, 18620.

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Accordingly, the Commission does not expect the rules, as proposed herein, to have a significant economic impact on a substantial number of small entities. Therefore, the Chairman, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C. 605(b), that the proposed amendments will not have a significant economic impact on a substantial number of small entities. The Commission invites the public

to comment on this finding and on its proposed determination that the trading facilities covered by these rules would not be small entities for purposes of the Regulatory Flexibility Act.

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#### B. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 imposes certain requirements on federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the PRA. The proposed rule amendments do not require a new collection of information on the part of any entities subject to these rules. Accordingly, for purposes of the Paperwork Reduction Act of 1995, the Commission certifies that these rule amendments do not impose any new reporting or recordkeeping requirements.

#### C. Cost-Benefit Analysis

Section 15 of the Act, as amended by section 119 of the CFMA, requires the Commission to consider the costs and benefits of its action before issuing a new regulation. The Commission understands that, by its terms, Section 15 does not require the Commission to quantify the costs and benefits of a new regulation or to determine whether the benefits of the proposed regulation outweigh its costs. Nor does it require that each proposed regulation be analyzed in isolation when that regulation is a component of a larger package of regulations or of rule revisions. Rather, section 15 simply

requires the Commission to ``consider the costs and benefits'' of its action.

Section 15(a) further specifies that costs and benefits shall be evaluated in light of five broad areas of market and public concern: protection of market participants and the public; efficiency, competitiveness, and financial integrity of futures markets; price discovery; sound risk management practices; and other public interest considerations. Accordingly, the Commission could, in its discretion, give greater weight to any one of the five enumerated areas of concern and could, in its discretion, determine that, notwithstanding its costs, a particular regulation was necessary or appropriate to protect the public interest, to effectuate any of the provisions, or to accomplish any of the purposes of the Act.

The proposed amendments constitute a package of amendments to Regulation 1.38 and to guidance that the Commission originally promulgated to implement the CFMA. The amendments are proposed in light of past experience with the implementation of the CFMA, and are intended to facilitate increased flexibility and consistency. Some sections of the proposed amendments merely clarify or make explicit past Commission decisions concerning transactions off the centralized market.

As most provisions incorporate rules previously approved by the Commission, the proposed amendments would not, in most cases, impose new costs on DCMs or market participants. Most current DCM rules already meet the acceptable practices proposed,

furthermore, these amendments incorporate standards that the Commission has previously determined protect market participants and the public,\42\ the financial integrity or price discovery function of the markets, and sound risk management practices. Moreover, the additional clarification of acceptable practices provides a benefit to markets and market participants. In addition, the amendments are expected to benefit efficiency and competition by providing more detailed guidance as to acceptable means of meeting the applicable designation criteria and core principles, allowing a greater degree of legal certainty to the markets and market participants.

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\42\ See, e.g. proposed Appendix B(9)(b)(2)(ii)(B) to Part 38. See also, supra notes 14-15 and accompanying text.

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After considering the five factors enumerated in the Act, the Commission has determined to propose the rules and rule amendments set forth below. The Commission invites public comment on its application of the cost-benefit provision. Commenters also are invited to submit any data that they may have quantifying the costs and benefits of the proposed rules with their comment letters.

List of Subjects in 17 CFR Parts 1 and 38

Block transactions, Commodity futures, Contract markets,

Transactions off the centralized market, Reporting and recordkeeping requirements.

In consideration of the foregoing, the Commission hereby proposes to amend Chapter I of Title 17 of the Code of Federal Regulations as follows:

PART 1--GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for Part 1 continues to read as follows:

Authority: 7 U.S.C.

2. Section 1.38 is proposed to be revised to read as follows:

Sec. 1.38 Execution of transactions.

(a) Transactions on the centralized market. All purchases and sales of any commodity for future delivery, and of any commodity option, on or subject to the rules of a contract market, shall be executed openly and competitively by open outcry, or posting of bids and offers, or by other equally open and competitive methods, in a place provided by the contract market, during the regular hours prescribed by the contract market for trading in such commodity or commodity option.

(b) Trades off the centralized market; requirements. Notwithstanding paragraph (a) of this section, transactions may be executed away from a centralized market, including by transfer trades, office trades, block trades, or trades involving the

exchange of  
futures for a commodity or for a derivatives position,  
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. Every person  
handling, executing,  
clearing, or carrying the trades, transactions or  
positions described  
in this paragraph shall comply with the rules of the  
appropriate  
contract market and derivatives clearing organization,  
including to  
identify and mark by appropriate symbol or designation  
all such  
transactions or contracts and all orders, records, and  
memoranda  
pertaining thereto.

#### PART 38--DESIGNATED CONTRACT MARKETS

3. The authority section for Part 38 continues to  
read as follows:

Authority: 7 U.S.C. 2, 5, 6, 6c, 7 and 12a, as  
amended by the  
Commodity Futures Modernization Act of 2000, Appendix E  
of Pub. L.  
106-554, 114 Stat. 2763 (2000).

4. In Appendix B to Part 38 Core Principle 9 is  
proposed to be  
revised to read as follows:

Appendix B to Part 38--Guidance on, and Acceptable  
Practices in,  
Compliance With Core Principles

\* \* \* \* \*

Core Principle 9 of section 5(d) of the Act:  
EXECUTION OF  
TRANSACTIONS--The board of trade shall provide a  
competitive, open,

and efficient market and mechanism for executing transactions.

(a) Application guidance--(1) Transactions on the centralized market. (i) All purchases and sales of any commodity for future delivery, and of any commodity option, on or subject to the rules of a contract market shall be executed openly and competitively by open outcry, or posting of bids and offers, or by other equally open and competitive methods, in a place provided by the contract market, during the regular hours prescribed by the contract market for trading in such commodity or commodity option.

(ii) A competitive and open market and mechanism for executing transactions includes a board of trade's methodology for entering orders and executing transactions.

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(iii) Appropriate objective testing and review of a contract market's automated systems should occur initially and periodically to ensure proper system functioning, adequate capacity and security.

A designated contract market's analysis of its automated system shall address compliance with appropriate principles for the oversight of automated systems, ensuring proper system functionality, adequate capacity and security.

(2) Transactions off the centralized market. (i) Transactions may be executed off the centralized market if transacted in accordance with written rules of a contract market that have been certified to or approved by the Commission and that specifically

provide for execution of such transactions away from the centralized market.

(ii) Every person handling, executing, clearing, or carrying the trades, transactions or positions that are not executed on the centralized market, including transfer trades, office trades, block trades, or trades involving the exchange of futures for a commodity or for a derivatives position, shall comply with the rules of the applicable designated contract market and derivatives clearing organization.

(iii) A designated contract market that determines to allow trades off the centralized market shall ensure that such trading does not operate in a manner that compromises the integrity of prices or price discovery on the centralized market.

(b) Acceptable practices--(1) Matters relating to trade execution facilities. (i) General provisions. [Reserved]

(ii) Electronic trading systems. (A) The guidelines issued by the International Organization of Securities Commissions (IOSCO) in 1990 (which have been referred to as the ``Principles for Screen-Based Trading Systems''), and adopted by the Commission on November 21, 1990 (55 FR 48670), as supplemented in October 2000, are appropriate guidelines for a designated contract market to apply to electronic trading systems.

(B) Any objective testing and review of the system should be performed by a qualified independent professional. A professional that is a certified member of the Information Systems

Audit and Control Association experienced in the industry is an example of an acceptable party to carry out testing and review of an electronic trading system.

(C) Information gathered by analysis, oversight, or any program of testing and review of any automated systems regarding system functioning, capacity and security must be made available to the Commission upon request.

(iii) Pit trading. [Reserved]

(2) Transactions off the centralized market--(i) General

provisions. (A) Types of allowable trades off the centralized market.--Acceptable transactions off the centralized market include: transfer trades, office trades, block trades, or trades involving the exchange of futures for a commodity or for a derivatives position, if transacted in accordance with written rules of a contract market appropriately providing for execution away from the centralized market, that have been certified to or approved by the Commission.

(B) Reporting. Acceptable contract market rules would require reporting of transactions off the centralized market to the contract market within a reasonable period of time.

(C) Publication. Acceptable contract market rules would require the contract market to publicize details about transactions off the centralized market immediately upon the receipt of the transaction report.

(D) Trade register. Acceptable contract market rules would

require the contract market to identify transactions off the centralized market on its trade register.

(E) Recordkeeping. Acceptable contract market rules would require parties to, and members facilitating, transactions off the centralized market to keep appropriate records. Appropriate records for transactions off the centralized market would comply with Core Principle 10 and Core Principle 17.

(F) Identification of trades. Section 1.38(b) of this chapter establishes the guidance regarding the identification of all trades off the centralized market. It requires contract market rules to require every person handling, executing, clearing, or carrying trades, transactions or positions that are executed off the centralized market, including transfer trades, office trades, block trades or trades involving the exchange of futures for a commodity or for a derivatives position, to identify and mark by appropriate symbol or designation all such transactions or contracts and all orders, records, and memoranda pertaining thereto.

(ii) Block transactions. (A) Include an acceptable minimum block size. An acceptable minimum block size would be no smaller than the customary size of large transactions in any relevant markets. A ``large'' transaction is one that may affect the quality of the transaction price due to the significant impact of such a large order on the centralized market. An acceptable minimum block size, for example, would be a transaction size that is greater than 90

percent of the trades in a relevant market. The relevant market should be the subject futures or options market, any related derivatives market, and/or the underlying cash market, as appropriate. If a contract market chooses to allow block participants to meet the minimum block size requirement by aggregating the component legs of a spread or combination position executed as a block trade, the acceptable size for each leg should be the size of a large transaction in the relevant market (that is, a size that is greater than 90 percent of the trades in the relevant market). For markets where transaction data in the relevant market(s) are unavailable, inadequate to conduct an analysis, or for markets where there is no underlying cash market, an acceptable minimum block size should be set initially at 100 contracts and adjusted thereafter as transaction data in the relevant market(s) become available.

(B) Restrict access to appropriate parties. Acceptable block trade parties would be eligible contract participants. However, contract market rules could also allow a commodity trading advisor registered pursuant to section 4m of the Act, or a principal thereof, including any investment advisor who satisfied the criteria of Sec. 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 total assets under management that exceed \$25,000,000.

(C) Aggregation of orders. Acceptable contract market rules would prohibit aggregation of orders for different accounts in order to satisfy the minimum size requirement except in appropriate circumstances. Aggregation of orders for different accounts in order to satisfy the minimum size requirement would be acceptable if done by a commodity trading advisor registered pursuant to section 4m of the Act, or a principal thereof, including any investment advisor who satisfies the criteria of Sec. 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, where such commodity trading advisor, investment advisor or foreign person has more than \$25,000,000 in total assets under management.

(D) Acting for a customer. Acceptable contract market rules would prohibit a person from effecting a block trade on behalf of a customer, unless the person has received an instruction or prior consent to do so from the customer;

(E) Recordkeeping. Acceptable contract market rules would require parties to, and members facilitating, a block trade to keep appropriate records. Appropriate block trade records would comply with Core Principle 10 and Core Principle 17. Records kept in accordance with the requirements of FASB Statement No.

(``Accounting for Derivative Instruments and Hedging Activities'')

would be acceptable records. Block trade orders must be recorded by the member and time-stamped with both the time the order was placed and the time the order was executed, and must indicate when block trades are between affiliated parties. When requested during an investigation, parties to, and members facilitating, a block trade shall provide records to document that the block trade is executed in conformance with contract market rules.

(F) Reporting. Acceptable contract market rules would require reporting of the block trade to the contract market within a reasonable period of time. Reporting periods previously approved by the Commission would be considered reasonable time periods for reporting a block transaction to the contract market once the transaction is executed.

(G) Publication. Acceptable contract market rules would require the contract market to publicize details about the block trade immediately upon its being reported to the contract market.

(H) Identification of trades. Acceptable contract market rules would require the contract market to identify block trades as such on its trade register, and to identify when block trades are between affiliated parties.

(I) Pricing. Acceptable contract market rules would require that the block trades be

at a price that is fair and reasonable. Consideration of whether a block transaction price is fair and reasonable could take into account: (i) The size of the block; and (ii) the price and size of other trades in any relevant markets at the applicable time, and the circumstances of the market or the parties to the block trade. Relevant markets could include, without limitation, the contract market itself, the underlying cash markets and/or other related futures markets. If a contract market rule requiring a fair and reasonable price includes the ``circumstances'' of the parties or of the market within its parameters, a block trade participant could execute a block transaction at a price that was 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.

(J) Arm's length transactions. Acceptable contract market rules would require that block trades be arm's length transactions. The following block trades will be presumed to be carried out at ``arm's length'' (1) Block trades transacted between separate counterparties (whether affiliated or not), where each counterparty has a separate account controller with its own responsibility to review and evaluate the terms and conditions and the potential risks and benefits of prospective transactions would be presumed to be carried out at ``arm's length;'' and (2) Block trades between affiliated parties if transacted under contract market rules that

require,  
along with the requirements of paragraphs (b)(2)(i)(A)-(H) of this appendix: (i) execution during the contract's trading hours; and  
(ii) transaction prices that fall within the bid/ask spread on electronic trading systems or prices of contemporaneous related trading floor transactions, however, if the contract does not have a bid/ask spread or any floor transactions at the time of the block transaction, then the contemporaneous bid/ask spread or price of transactions on related futures or cash markets could be used.

(iii) Exchange of futures for a commodity or for a derivatives position. Acceptable contract market rules for exchange of futures for a commodity or for a derivatives position would require that such trades include the following elements:

(A) Separate but integrally related transactions, involving (1) the same or a related commodity; (2) price correlation of legs; and  
(3) quantitative equivalence;

(B) A buyer of futures who is the seller of the corresponding commodity or derivatives position and a seller of futures who is the buyer of the corresponding commodity or derivatives position; and

(C) An actual transfer of ownership, involving (1) separate parties; (2) possession, right of possession, or right to future possession of each leg prior to the trade; (3) an ability to perform; and (4) a transfer of title.

(iv) Office trades. [Reserved]

(v) Transfer trades. [Reserved]

\* \* \* \* \*

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Commission.

Jean A. Webb,  
Secretary of the Commission.

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