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Regulation of a Demutualized Derivatives Exchange (United States)

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10.1 Introduction

The Commodity Futures Trading Commission (CFTC) has regulated commodity futures and option markets in the United States for the past quarter century.² Until recently, virtually all exchanges were structured as non-profit membership organizations. Competitive pressures now have convinced existing exchanges to reexamine traditional business models – and in some cases demutualize – and have encouraged new markets to launch as for-profit nonmutualized entities.³ At the same time, the US Congress has enacted a sweeping and deregulatory revision of the *Commodity Exchange Act (Act)*,⁴ and the CFTC has revised its regulations accordingly.

The CFTC's new regulatory framework was developed to foster diversity in derivatives markets through deregulation, but exchanges already were testing new business strategies within the existing regulatory structure. The CFTC has viewed exchange demutualization plans and new exchange applications through the same lens as mutualized exchange submissions. Although some unique issues do surface,

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² The Commodity Futures Trading Commission (CFTC) was formed in 1975, but futures have been subject to federal regulation since 1922.

³ To demutualize means to convert from a member-owned organization to a shareholder-owned organization, typically from a not-profit entity. Demutualization has been making headlines in the United States for the past few years and has been widely viewed as a means for exchanges to streamline governance and management, to improve and expedite decision making, and to raise capital. Appendix 1 provides an overview of regulated US derivatives exchanges and their business models.

⁴ *Commodity Exchange Act*, 7 U.S.C. § 1 et seq. (1994).

demutualized and nonmutualized exchanges continue to be regulated much the same as mutualized exchanges.

This chapter is intended to provide an overview of CFTC's regulation of derivatives exchanges.⁵ Part 10.2 of the chapter highlights changes created by the recent legislation with regard to new types of derivatives markets. Part 10.3 reviews CFTC's oversight authority over regulated exchanges. Part 10.4 identifies some issues raised when an exchange chooses to demutualize and discusses these issues in light of the CFTC's recently promulgated regulations.

10.2 A New Framework

The *Commodity Futures Modernization Act (CFMA)*,⁶ signed into law by the President on 21 December 2000, redefines the CFTC's mission⁷ and transforms the way financial markets may trade derivatives in the United States.⁸ The *CFMA* changed both the role of the CFTC and the scope of its authority. CFTC is no longer a "front-line" regulator; instead, it must "oversee" markets and their participants. So-called prescriptive regulations are being replaced with regulations that establish general criteria and broad core principles.⁹ Moreover, the scope of the CFTC's regulatory authority varies depending on the type of transaction and

⁵ This chapter reflects solely the author's views and not the views of the Commodity Futures Trading Commission (CFTC) or any office or division of CFTC.

⁶ *Commodity Futures Modernization Act of 2000 (CFMA)*, Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000), available at <<http://www.cftc.gov/files/ogc/ogchr5660.pdf>>.

⁷ New Section 3 of the *Act* envisions a "system of effective self-regulation ... under the oversight of CFTC" and lists four regulatory goals: (i) to deter and prevent price manipulation or any other disruptions to market integrity; (ii) to ensure the financial integrity of all transactions subject to this Act and the avoidance of systemic risk; (iii) to protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets; and (iv) to promote responsible innovation and fair competition among boards of trade, other markets and market participants.

⁸ In addition, the *CFMA* specifically excluded certain over-the-counter bilateral transactions from the CFTC's jurisdiction, excluded electronic principal-to-principal trading of an excluded commodity between "eligible contract participants," clarified the CFTC's jurisdiction over certain aspects of the retail market in foreign exchange trading, gave the CFTC authority to regulate clearing organizations, and reauthorized the CFTC for five years. The *CFMA* also repealed the Shad-Johnson jurisdictional accord between the CFTC and the U.S. Securities and Exchange Commission (SEC), thereby lifting the ban on single-stock futures, and established a new regulatory regime for security futures products. The CFTC has exclusive jurisdiction over broad-based security indices and shares jurisdiction with the SEC over futures on individual securities and narrow-based security indices. The two agencies are drafting regulations to enable the trading of these products.

⁹ The term "core principle" is not defined in either the *CFMA* or CFTC's regulations.

facility, the type of underlying commodity, and the type of participant. The *CFMA* constructs a complex matrix in which a wide range of financial commodities are deemed “excluded” commodities and all but agricultural commodities are “exempt” commodities. CFTC-regulated markets may choose to trade contracts on any commodity, whether included, exempted, or excluded.¹⁰

The *Act* now provides for two tiers of markets, each of which contains two types of markets:

Regulated Markets

- designated contract markets (DCMs); and
- registered derivatives transaction execution facilities (DTFs).

Exempt Markets

- exempt commercial markets (ECMs); and
- exempt boards of trade (EBOTs).¹¹

Generally, the CFTC has less oversight responsibility where markets limit access to more sophisticated participants and trade commodities unlikely to be susceptible to manipulation. DCMs are regulated most like traditional derivatives exchanges, DTFs operate under an intermediate level of regulation, and the exempt markets enjoy minimal regulation.

¹⁰ Some have raised concerns about the CFTC’s jurisdiction under the *CFMA* when, for example, a market in excluded commodities gains the CFTC designation or registration. See, e.g., Dissent of Commissioner Thomas J. Erickson to Rules Implementing the Commodity Futures Modernization Act (*CFMA*) with Respect to Transaction Execution Facilities, 66 Fed. Reg. 42256, at 42288-89 (10 August 2001), available at <<http://www.cftc.gov/files/foia/fedreg01/foi010810a.pdf>>; Remarks of Commissioner Thomas J. Erickson, Commodity Futures Trading Commission, New York State Bar Association, Committee on Futures and Derivatives Law (22 February 2001), available at <<http://www.cftc.gov/opa/speeches01/opaericks-9.htm>>.

¹¹ The CFTC has implemented the statutory provisions of the *CFMA* by promulgating regulations for DCMs in Part 38 of its regulations, for DTFs in Part 37, and for the two exempt markets in Part 36. CFTC also provided guidance through non-exclusive safe harbors for DCMs and DTFs in Appendices A and B to Parts 38 and 37, respectively. See <<http://www.cftc.gov/opa/press01/opa4547-01.htm>>. The regulations will be compiled at 17 C.F.R. Ch. I (2002).

10.2.1 Designated Contract Markets

Boards of trade¹² designated as contract markets may list for trading futures or option contracts on any underlying commodity, index, or instrument and may allow access to their facilities by all types of participants, including retail customers. Those boards of trade that existed at the time of the *CFMA*'s enactment are considered to be DCMs. Applicants for initial designation must satisfy certain criteria: adherence to designation criteria, prevention of market manipulation, fair and equitable trading, enforcement of rules on the trade execution facility, financial integrity of transactions, disciplinary procedures, public access to information on the contract market, and the ability to obtain information. They also must demonstrate the ability to comply with, and once designated must comply with, 18 core principles.¹³

10.2.2 Registered Derivatives Transaction Execution Facilities

Boards of trade registered as DTFs may list for trading futures or option contracts on commodities that have a nearly inexhaustible deliverable supply, have a deliverable supply sufficiently large that the contract is highly unlikely to be susceptible to the threat of manipulation, have no cash market, are security futures products, or have been determined (on a case-by-case basis) by CFTC to be highly unlikely to be susceptible to the threat of manipulation.¹⁴ DTFs may allow access to their facilities by “eligible contract participants” or by any other person trading through a registered futures commission merchant (FCM) with, among other things, at least US\$20 million in net capital. Those DTFs that permit only “eligible commercial entities” to trade for their own accounts may offer contracts on a wider range of commodities (all but agricultural commodities specifically enumerated in Section 1a(4) of the

¹² New Section 1a(2) of the Act defines “board of trade” as “any organized exchange or other trading facility.” This paper uses the term “exchange” in its generic sense to refer to regulated derivatives markets.

¹³ See generally new Section 5 of the Act. Appendix 1 of this chapter lists the designation criteria and core principles applicable to DCMs.

¹⁴ Pursuant to new Section 5a(g) of the Act and Regulation 37.4, if a DTF chooses to trade agreements, contracts, or transactions involving excluded or exempt commodities, the CFTC has exclusive jurisdiction over these agreements, contracts, and transactions to the extent that they are traded on a DTF.

Act).¹⁵ Applicants must satisfy certain criteria: adherence to registration criteria, deterrence of abuses, enforcement of trading procedures, and financial integrity of transactions.¹⁶ They also must certify that they have the capacity to comply with, and upon commencing operations must comply with, nine core principles.¹⁷

10.2.3 Exempt Commercial Markets

Electronic trading facilities operating as ECMs may provide for the execution or trading of agreements, contracts, or transactions in all commodities but agricultural commodities specifically enumerated in Section 1a(4) of the Act. They must limit access to their facilities to “eligible commercial entities” trading for their own accounts. ECMs must file a notice and certifications with CFTC and comply with informational, record keeping, and other requirements. They are subject to the Act’s antifraud and anti-manipulation provisions and, if CFTC finds that they perform a price discovery function, they must provide certain pricing information to the public. ECMs may not claim to be registered with or recognized, designated, licensed, or approved by the CFTC.¹⁸

10.2.4 Exempt Boards of Trade

Boards of trade electing to operate as EBOTs may list for trading only futures or option contracts on commodities (not securities) that have a nearly inexhaustible deliverable supply, have a deliverable supply sufficiently large and a cash market sufficiently liquid that the contract is highly unlikely to be susceptible to the threat of manipulation, or have no

¹⁵ Enumerated commodities are wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Irish potatoes, wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice. At some point in the future, the CFTC may consider approving contracts on such commodities.

¹⁶ Regulation 37.5(a) provides that existing DCMs may simply notify CFTC of their intent to operate as DTFs and file their DTF rules (or a list of such rules) and a certification with the CFTC that they meet the requirements for trading and criteria for designation. New Section 5a(b)(4) requires DCMs either to provide a separate physical location for their DTFs or, for electronic trading, to identify whether the trading is occurring on a DCM or on a DTF.

¹⁷ See generally new Section 5a of the Act. Appendix 2 of this chapter lists the registration criteria and core principles applicable to DTFs.

¹⁸ See generally new Section 2(h)(3)-(5) of the Act.

cash market.¹⁹ They are not limited to principal-to-principal trading, but must limit access to their facilities to “eligible contract participants.” EBOTs need only to file a notice with CFTC and are subject only to the Act’s antifraud and anti-manipulation provisions.²⁰ If CFTC finds that they perform a price discovery function, however, they must provide certain pricing information to the public. EBOTs may not claim to be registered with or recognized, designated, licensed, or approved by CFTC.²¹

10.3 Exchange Oversight

The *CFMA* creates a new array of possibilities—and greater responsibilities—for derivatives markets. They not only will face challenging business decisions that will demand resolution with greater expediency, but also will bear increased self-regulatory responsibility. No longer constrained by what some termed restrictive regulations, markets will be challenged to develop more creative solutions²² and will be required to answer to a broader constituency than the traditional collective of exchange members.

At the same time, CFTC will be mapping the contours of regulatory oversight under the *CFMA*. The scope of a market’s self-regulatory responsibility varies depending upon whether it is a DCM, a DTF, an ECM, or an EBOT – not upon whether it is demutualized or mutualized. Over the next several years, the CFTC, the self-regulatory organizations (SROs),²³ and maybe even the courts will have a voice in how this responsibility will be allocated.

¹⁹ Pursuant to new Section 5d(e) of the *Act*, the CFTC has exclusive jurisdiction over any account, agreement, contract, or transaction involving a contract of sale of a commodity for future delivery, or option on such a contract or on a commodity, to the extent that the account, agreement, contract, or transaction is traded on an EBOT.

²⁰ New Section 5d(f) of the *Act* provides that DCMs and DTFs may operate EBOTs by establishing separate subsidiaries or other legal entities.

²¹ See generally new Section 5d of the *Act*.

²² Today’s markets have a wide range of choices: trade cash, futures, options, over-the-counter derivatives, and/or debt and equity securities; link or form alliances; acquire or be acquired by other entities; form new subsidiaries or holding companies; branch out or establish other businesses. As regulatory restrictions loosen and technological capability expands, however, markets also face an ever-widening range of competitors.

²³ Self-regulatory organizations (SROs), i.e., DCMs, DTFs, derivatives clearing organizations, and the National Futures Association (NFA), must enforce minimum financial and reporting requirements for their members, among other responsibilities. To date, the NFA is the sole futures association registered under the *Act*. NFA is responsible, with CFTC oversight, for certain aspects of regulating CFTC’s registrants and focuses primarily on the qualifications and proficiency, financial condition, retail sales practices, and business conduct of these futures professionals.

CFTC oversight of regulated exchanges will focus on reviewing their adherence to the core principles²⁴ governing their compliance with the Act and CFTC regulations.²⁵ Rule enforcement reviews conducted by the CFTC's Division of Trading and Markets (Division) will continue to ascertain exchanges' ongoing fulfillment of self-regulatory obligations.²⁶ Upon request, DCMs must provide the CFTC with information related to their business as a contract market and with a written demonstration that they are in compliance with one or more core principles. DCMs remain subject to the reporting provisions in Parts 15 and 16 of the CFTC's existing regulations, as well as to CFTC's special call provisions in Part 21. The new regulations require DTFs to provide the CFTC, upon request, with information to enable CFTC "to satisfy its statutory obligations" and with a written demonstration that they are in compliance with one or more core principles. DTFs face reduced reporting requirements but are subject to special call requirements under the new regulations.²⁷

The Act vests the CFTC with a range of potential responses to exchange noncompliance. If CFTC determines, based on substantial evidence, that a DCM or DTF is violating a core principle, the CFTC may provide notice to the exchange, give it 30 days to comply, and take further action if the exchange fails to take curative action. The commission may alter or supplement, after notice and opportunity for hearing, an exchange's rule(s) if changes have not been made and are necessary or appropriate to protect producers or traders or to ensure fair dealing. In addition, CFTC has the authority to take action against an exchange making a false statement and to suspend or revoke an exchange's designation or registration for violating the Act, any regulation, or order, or for an exchange's failure to enforce its own rules.

²⁴ Exchanges generally no longer are required to seek CFTC's approval of their rules and rule amendments. Although this change was implemented prior to the CFMA's enactment, new Section 5c(c) of the Act and new Regulations 38.4(a) and 37.7(c) make clear that CFTC's approval is voluntary for DCMs and DTFs, respectively.

²⁵ The CFTC also will use surveillance to spot unusual market events that can reveal systemic problems and risks. Appendix 3 provides background on the CFTC's market surveillance program.

²⁶ The Division oversees SRO compliance activities. Its rule enforcement reviews examine the adequacy of each exchange's program for enforcing its market surveillance, trade practice surveillance, audit trail, disciplinary, and financial and sales practice rules, as well as rules governing conflicts of interest.

²⁷ For DCMs, see new Regulations 38.2 and 38.5 and, for DTFs, see Regulations 37.6(c) and 37.8. In addition, ECMs are subject to special calls pursuant to new Section 2(h)(5)(B)(iii) of the Act and Regulation 36.3(b)(2).

10.4 Regulatory Issues Raised by Demutualization

10.4.1 Conflicts of Interest

Do demutualized exchanges raise greater concerns about conflicts of interest than mutualized exchanges?

Mutualized exchanges answer to their members. Once demutualized, exchanges must protect their owners' interests. Although an exchange's members initially may be the exchange's owners, they eventually may choose to sell their ownership interests in the exchange. The new owners may have no interest in trading and may be disinterested in the exchange beyond reaping a return on their investment.²⁸ The exchange, however, must continue to maintain an effective program of self-regulation. A conflict of interest may arise if an attempt to fulfill self-regulatory obligations negatively affects the profitability of a demutualized exchange. A conflict also may arise in disciplinary proceedings involving an exchange participant who is the owner, or a significant shareholder, of a competing exchange.²⁹

Conflicts of interest inherent in self-regulation manifest equally, albeit differently, in demutualized and mutualized entities. After all, traditional exchanges are run by members interested in making money and enhancing value through trading and maximizing seat value. Furthermore, exchange disciplinary programs where members sanction fellow members arguably can affect the rigor of an exchange's self-regulatory program. Even if conflicts are heightened in a demutualized environment, exchanges would continue to have a vested interest in preserving their reputations for providing fair and efficient markets. These exchanges ultimately would bear a heavy price in sacrificing good will and their reputations in the interest of short-term profits.

The CFTC's new regulatory framework explicitly addresses conflicts of interest for both types of regulated exchanges. For DCMs and DTFs, Core Principles 15 and 7, respectively, state that they "shall establish and enforce rules to minimize conflicts of interest in the decision making

²⁸ While this divergence of interests may exist regardless of whether such an exchange is privately or publicly owned, the divergence would be greater in the case of a publicly traded exchange because its shareholders are less likely to be market participants. In addition, shareholder interests may be protected by shareholder derivative litigation or shareholder class actions, at the expense of market participants.

²⁹ The securities industry is facing the additional complication of exchanges listing their own shares. However, until derivatives exchanges begin to offer contracts on single equities, the Commodity Futures Trading Commission does not yet share analogous concerns.

process ... and establish a process for resolving such conflicts of interest.” CFTC’s guidance explains that exchanges should develop methods to ascertain the presence of conflicts of interest and to make decisions in the event of such conflicts. Moreover, exchanges should provide for appropriate limitations on the use or disclosure of material non-public information gained through the performance of official duties by board members, committee members, and employees or gained through an ownership interest in the facility.³⁰

10.4.2 Exchange Governance

Does exchange governance warrant greater scrutiny at demutualized exchanges?

Mutualized exchanges are governed by boards of directors that must reflect the composition of their membership and must represent the interests of a variety of market participants. Upon demutualization, boards of directors must comply with state governance laws that may have different composition requirements. A demutualized exchange’s board of directors must heed owner interests, which may no longer align with the interests of market participants.

The *CFMA* imposes board composition requirements solely upon DCMs that are mutually owned. For such DCMs, Core Principle 16 states that they “shall ensure that the composition of the governing board reflects market participants.” Fitness requirements, however, apply to those who exercise governance responsibilities or control over regulated exchanges, whether demutualized or mutualized. For DCMs and DTFs, Core Principles 14 and 6, respectively, state that they “shall establish and enforce appropriate fitness standards” for directors, disciplinary committee members, exchange members,³¹ any other persons with direct access³² to the exchange, and any parties affiliated with any of these types of persons. The CFTC’s guidance provides that eligibility criteria should include standards for fitness and for collecting and verifying information that supports compliance with such standards. Information

³⁰ Pursuant to new Regulations 38.2 and 37.2, DCMs and DTFs, respectively, remain subject to existing limitations in Regulation 1.59(d) with respect to material, non-public information.

³¹ An exchange’s owner(s) would have governance authority at a demutualized exchange. Regulations 38.3(b)(4) and 37.6(d)(5) provide that the core principle on fitness requires demutualized DCMs and DTFs, respectively, to establish fitness requirements for all natural persons that directly or indirectly have greater than a 10% ownership interest in the facility.

³² In the preamble to its final rules, the CFTC noted that fitness standards do not apply to customers who have direct trading access but exercise no governance authority.

substantiating a person's fitness may include registration information, a certification of fitness, an affidavit by the exchange's counsel, or other information.

10.4.3 Delegating or Outsourcing Self-Regulatory Obligations

Does self-regulation suffer if exchanges contract with third parties for the performance of their SRO responsibilities?

Mutualized exchanges traditionally maintain in-house SRO programs. Once demutualized, exchanges may respond to their owners' desire to reduce expenses by shifting certain SRO functions to third parties.³³ In today's competitive environment, however, both demutualized and mutualized exchanges must strive to minimize costs while maintaining effective SRO programs.

Section 5c(b) of the *CFMA* provides that DCMs and DTFs may comply with any applicable core principle by delegating any relevant function to a registered futures association or another registered entity.³⁴ A few newly-approved DCMs already have contracted at least some self-regulatory functions to the NFA. The CFTC obtains detailed descriptions of how SRO obligations would be fulfilled and reviews the contractual agreements in assessing these arrangements. DCMs, as well as DTFs, remain responsible for carrying out each delegated function and must assure themselves that they remain in compliance with the Act's requirements. The CFTC has the authority to intervene if an exchange

³³ Adequate funding for self-regulatory programs is essential for any exchange. A demutualized exchange eager to reduce costs could decide to trim its budget by reducing self-regulatory programs. Perhaps an exchange would choose to base payments to third-party vendors on transaction volume (transaction fees) or a percentage of the dollar value of transactions rather than paying a set dollar amount. Such a payment structure potentially could dedicate insufficient resources to self-regulatory obligations. However, these risks exist for mutualized exchanges as well.

³⁴ Designation Criterion 6 for DCMs explicitly states that DCMs may delegate their disciplinary programs to third parties. Although the CFTC's new regulations do not address delegation or outsourcing, its guidance for DCMs contemplates delegation of several functions: market surveillance, trade practice surveillance, financial review and audits of intermediaries, and customer dispute resolution. Moreover, the preamble to the final regulations explains that DCMs and DTFs also may outsource specified activities, such as the operation of a trading platform, to third parties. Delegation confers the authority to act in the delegating entity's name. For example, an exchange that delegates its member discipline and market surveillance empowers its delegatee to take appropriate remedial actions, including sanctioning members or market participants for rule violations. In contrast, if an exchange contracts with an entity to conduct trade surveillance and to investigate alleged rule infractions, the contractor would not have the authority to decide on behalf of the exchange whether an infraction had occurred or to impose remedial sanctions.

does not adequately perform its self-regulatory functions and may hold an exchange accountable for compliance failures and disciplinary violations.

10.5 Conclusion

The US Congress and the CFTC have developed a regulatory structure that is designed to encourage creativity. Exchanges undoubtedly will test the boundaries of the *CFMA* and the CFTC's new regulatory framework as they explore new business possibilities. Corporate structure will be but one of many business decisions for an exchange and but one facet in the CFTC's review of the exchange.

The *CFMA* creates a new regulatory template for CFTC to apply in a world of new markets, new products, and even new market participants. Exchange oversight must respect diversity but protect market integrity and transparency. The CFTC is entrusted with the public interest in liquid, fair, and financially secure markets.

APPENDIX I:

DESIGNATED CONTRACT MARKETS FOR REGULATED US DERIVATIVES EXCHANGES*

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| Board of Trade of the City of New York Established (merger rules approved) 4/24/98: http://www.cftc.gov/opa/press98/opa4138-98.htm | New York not-for-profit corporation (parent company of three designated contract markets: Coffee, Sugar & Cocoa Exchange , established 1882 and designated 1975; New York Cotton Exchange , established 1870 and designated 1936; New York Futures Exchange , established 1979 and designated 1980) |
| BrokerTec Futures Exchange Designated 6/18/01: http://www.cftc.gov/opa/press01/opa4526-01.htm | Delaware for-profit limited liability company |
| Cantor Financial Futures Exchange Designated 9/4/98: http://www.cftc.gov/opa/press98/opa4186-98.htm | New York not-for-profit corporation (joint venture of the NYCE and a subsidiary of Cantor Fitzgerald) |
| Chicago Board of Trade Established 1848 and designated 1923 Step one of reorganization plan approved 8/7/00: http://www.cftc.gov/opa/press00/opa4434-00.htm | Delaware not-for-profit non-stock corporation (step two of restructuring plan pending) |
| Chicago Mercantile Exchange Established 1919 and designated 1936 Demutualization plan approved 6/15/00: http://www.cftc.gov/opa/press00/opa4407-00.htm | Delaware for-profit corporation |
| FutureCom Designated 3/13/00: http://www.cftc.gov/opa/press00/opa4378-00.htm | Texas for-profit limited partnership |
| Kansas City Board of Trade Established 1856 and designated 1923 (incorporated 1973) | Delaware for-profit corporation |
| Merchant's Exchange of St. Louis Established 1836 and designated 7/10/00: http://www.cftc.gov/opa/press00/opa4421-00.htm | Missouri for-profit limited liability company |

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| MidAmerica Exchange Established 1848 and designated 1922 | Wholly-owned subsidiary of CBOT (acquired in 1986) |
| Minneapolis Grain Exchange Established 1881 (as Minneapolis Chamber of Commerce) and designated 1923 | Minnesota not-for-profit corporation |
| NASDAQ/LIFFE Futures Exchange Designated 8/21/01: http://www.cftc.gov/opa/press01/opa4559-01.htm | Delaware for-profit limited liability company |
| New York Mercantile Exchange Established 1872 and designated 1936 Demutualization plan approved 7/26/00: http://www.cftc.gov/opa/press00/opa4427-00.htm | Delaware for-profit non-stock corporation (consisting of two divisions) that is a subsidiary of a for-profit stock holding company, NYMEX Holdings, Inc. (exchange was formed via a 1994 merger between two contract markets: NYMEX and the Commodity Exchange , established 1933 and designated 1975) |
| OnExchange Board of Trade Designated 12/22/00: http://www.cftc.gov/opa/press00/opa4483-00.htm | Delaware for-profit corporation |

APPLICANTS FOR CM DESIGNATION

Hedge Street

Applied 3/13/01 (stayed)

Island Futures Exchange

Applied 11/27/01 (pending)

One Chicago

Applied 1/14/02 (pending)

* Only operational or newly designated contract markets are included. To date, no entities are registered as derivatives transaction execution facilities and none have filed notices as exempt boards of trade. Three entities have filed notices as exempt commercial markets: Intercontinental Exchange, LLC; Optionable, Inc.; and the International Maritime Exchange. For a list of registered derivatives clearing organizations, please visit the Commodity Futures Trading Commission's (CFTC) website at: <http://www.cftc.gov/dea/dearegistered_dco.htm>

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DESIGNATION CRITERIA

1. *In general.* To be designated as a contract market, the board of trade shall demonstrate to the CFTC that the board of trade meets the criteria specified in this subsection [Section 5(b) of the Act].
2. *Prevention of market manipulation.* The board of trade shall have the capacity to prevent market manipulation through market surveillance, compliance, and enforcement practices and procedures, including methods for conducting real-time monitoring of trading and comprehensive and accurate trade reconstructions.
3. *Fair and equitable trading.* The board of trade shall establish and enforce trading rules to ensure fair and equitable trading through the facilities of the contract market, and the capacity to detect, investigate, and discipline any person that violates the rules. The rules may authorize: (a) transfer trades or office trades; (b) an exchange of—(i) futures in connection with a cash commodity transaction; (ii) futures for cash commodities; or (iii) 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.
4. *Trade execution facility.* The board of trade shall: (a) establish and enforce rules defining, or specifications detailing, the manner of operation of the trade execution facility maintained by the board of trade, including rules or specifications describing the operation of any electronic matching platform; and (b) demonstrate that the trade execution facility operates in accordance with the rules or specifications.
5. *Financial integrity of transactions.* 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.

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6. *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.
7. *Public access.* The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade.
8. *Ability to obtain information.* The board of trade shall establish and enforce rules that will allow the board of trade to obtain any necessary information to perform any of the functions described in this subsection, including the capacity to carry out such international information-sharing agreements as the CFTC may require.

CORE PRINCIPLES

1. *In general.* To maintain the designation of a board of trade as a contract market, the board of trade shall comply with the core principles specified in this subsection [Section 5(d) of the Act]. The board of trade shall have reasonable discretion in establishing the manner in which it complies with the core principles.
2. *Compliance with rules.* The board of trade shall monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.
3. *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.
4. *Monitoring of trading.* The board of trade shall monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.
5. *Position limitations or accountability.* To reduce the potential threat

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of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate.

6. *Emergency authority.* The board of trade shall adopt rules to provide for the exercise of emergency authority, in consultation or cooperation with the CFTC, where necessary and appropriate, including the authority to: (a) liquidate or transfer open positions in any contract; (b) suspend or curtail trading in any contract; and (c) require market participants in any contract to meet special margin requirements.
7. *Availability of general information.* The board of trade shall make available to market authorities, market participants, and the public information concerning: (a) the terms and conditions of the contracts of the contract market; and (b) the mechanisms for executing transactions on or through the facilities of the contract market.
8. *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.
9. *Execution of transactions.* The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions.
10. *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 for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market.
11. *Financial integrity of contracts.* The board of trade shall establish and enforce rules providing for the financial integrity of any contracts traded on the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization), and rules to ensure the financial integrity of any futures

Appendix I: Designated Contract Markets for Regulated US Derivatives Exchanges

commission merchants and introducing brokers and the protection of customer funds.

12. *Protection of market participants.* 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.
13. *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.
14. *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 persons with direct access to the facility (including any parties affiliated with any of the persons described in this paragraph).
15. *Conflicts of interest.* The board of trade shall establish and enforce rules to minimize conflicts of interest in the decision-making process of the contract market and establish a process for resolving such conflicts of interest.
16. *Composition of boards of mutually owned contract markets.* In the case of a mutually-owned contract market, the board of trade shall ensure that the composition of the governing board reflects market participants.
17. *Record keeping.* The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the CFTC for a period of five years.
18. *Antitrust considerations.* Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall endeavor to avoid:
(a) adopting any rules or taking any actions that result in any unreasonable restraints of trade; or
(b) imposing any material anticompetitive burden on trading on the contract market.

APPENDIX 2:

Registered Derivatives Transaction Execution Facilities

REGISTRATION CRITERIA

1. *In general.* To be registered as a registered derivatives transaction execution facility, the board of trade shall be required to demonstrate to the CFTC only that the board of trade meets the criteria specified in [Section 5a(b) of the Act] and this subsection [Section 5a(c) of the Act].
2. *Deterrence of abuses.* The board of trade shall establish and enforce trading and participation rules that will deter abuses and has the capacity to detect, investigate, and enforce those rules, including means to: (a) obtain information necessary to perform the functions required under this section; or (b) use technological means to—(i) provide market participants with impartial access to the market; and (ii) capture information that may be used in establishing whether rule violations have occurred.
3. *Trading procedures.* The board of trade shall establish and enforce rules or terms and conditions defining, or specifications detailing, trading procedures to be used in entering and executing orders traded on the facilities of the board of trade. The rules may authorize: (a) transfer trades or office trades; (b) an exchange of—(i) futures in connection with a cash commodity transaction; (ii) futures for cash commodities; or (iii) 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 registered derivatives transaction execution facility or a derivatives clearing organization.
4. *Financial integrity of transactions.* The board of trade shall establish and enforce rules or terms and conditions providing for the financial

Appendix 2: Registered Derivatives Transaction Execution Facilities

integrity of transactions entered on or through the facilities of the board of trade, and rules or terms and conditions to ensure the financial integrity of any futures commission merchants and introducing brokers and the protection of customer funds.

CORE PRINCIPLES

1. *In general.* To maintain the registration of a board of trade as a derivatives transaction execution facility, a board of trade shall comply with the core principles specified in this subsection [Section 5a(d) of the Act]. The board of trade shall have reasonable discretion in establishing the manner in which the board of trade complies with the core principles.
2. *Compliance with rules.* The board of trade shall monitor and enforce the rules of the facility, including any terms and conditions of any contracts traded on or through the facility and any limitations on access to the facility.
3. *Monitoring of trading.* The board of trade shall monitor trading in the contracts of the facility to ensure orderly trading in the contract and to maintain an orderly market while providing any necessary trading information to the CFTC to allow the CFTC to discharge the responsibilities of the CFTC under the Act.
4. *Disclosure of general information.* The board of trade shall disclose publicly and to the CFTC information concerning: (a) contract terms and conditions; (b) trading conventions, mechanisms, and practices; (c) financial integrity protections; and (d) other information relevant to participation in trading on the facility.
5. *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 contracts traded on the facility if the CFTC determines that the contracts perform a significant price discovery function for transactions in the cash market for the commodity underlying the contracts.

Appendix 2: Registered Derivatives Transaction Execution Facilities

6. *Fitness standards.* The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members, and any other persons with direct access to the facility, including any parties affiliated with any of the persons described in this paragraph.
7. *Conflicts of interest.* The board of trade shall establish and enforce rules to minimize conflicts of interest in the decision-making process of the derivatives transaction execution facility and establish a process for resolving such conflicts of interest.
8. *Record keeping.* The board of trade shall maintain records of all activities related to the business of the derivatives transaction execution facility in a form and manner acceptable to the CFTC for a period of five years.
9. *Antitrust considerations.* Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall endeavor to avoid:
 - (a) adopting any rules or taking any actions that result in any unreasonable restraint of trade; or
 - (b) imposing any material anticompetitive burden on trading on the derivatives transaction execution facility.

APPENDIX 3:

The Commodity Futures Trading Commission (CFTC) Market Surveillance Program

Futures prices are widely quoted and disseminated throughout the US and abroad. Business, agricultural, and financial enterprises use futures markets for pricing information and for hedging against price risk. The goals of the CFTC's market surveillance program are to preserve these economic functions of the futures and option markets under its jurisdiction by monitoring trading activity to detect and prevent manipulation or abusive practices, to keep the commission informed of significant market developments, to enforce CFTC and exchange speculative position limits, and to ensure compliance with CFTC reporting requirements.

The Market Surveillance Mission

The primary mission of the market surveillance program is to identify situations that could pose a threat of manipulation and to initiate appropriate preventive actions. Each day, for all active futures and option contract markets, the CFTC's market surveillance staff monitors the daily activities of large traders, key price relationships, and relevant supply and demand factors in a continuous review for potential market problems.

Despite the great diversity among the underlying commodities on which futures contracts are based, from a surveillance perspective markets can be grouped according to their settlement provisions.

Physical-delivery commodities. Futures contracts that require the delivery of a physical commodity are most susceptible to manipulation when the deliverable supply on such contracts is small relative to the size of positions held by traders, individually or in related groups, as the contract approaches expiration. The more difficult and costly it is to augment deliverable supplies within the time constraints of the expiring futures contract's delivery terms, the more susceptible to manipulation the contract becomes.

Appendix 3: The CFTC Market Surveillance Program

Pertinent surveillance questions for such markets are the following:

- (i) are the positions held by the largest long trader(s) greater in size deliverable supplies not already owned by such trader(s)?
- (ii) are the long traders likely to demand delivery?
- (iii) is taking delivery the least costly means of acquiring the commodity?
- (iv) to what extent are the largest short traders capable of making delivery?
- (v) is making futures delivery a better alternative than selling the commodity in the cash market?
- (vi) is the futures price, as the contract approaches expiration, reflecting the cash market value of the deliverable commodity?
- (vii) is the price spread between the expiring future and the next delivery month reflective of underlying supply and demand conditions in the cash market?

An excellent barometer for potential liquidation problems is the basis relationship (i.e., the cash and futures price difference). When the price of the liquidating future is abnormally higher than underlying cash prices or both the futures and underlying cash price are abnormally higher than comparable cash prices, there is ample reason to examine the causes and to assess the motives of traders holding long futures positions.

Financial instruments. Futures contracts that require the delivery of a financial instrument generally are less likely than futures on physical commodities to be subject to manipulation in the form of squeezes. This assertion is based on the premise that the underlying cash markets for financial instruments tend to be deeper, more liquid, more transparent, and more readily arbitrated than physical commodity markets. Nonetheless, certain of the questions specified above still pertain, particularly when the above-stated assumptions do not hold. For example, when the particular financial futures contract provides for a deliverable supply that either is of finite size or is a narrow segment of the broader cash market for the underlying financial instrument, all the

Appendix 3: The CFTC Market Surveillance Program

questions raised in the prior section on physical commodities would apply.

In addition, price aberrations in the cash market for the underlying financial instrument may provide an indication of (or an opportunity for) an attempted manipulation. Surveillance staff monitor cash prices for the financial instrument specified for delivery on the futures contract in relation to cash prices for non-deliverable instruments that would be close, or identical, substitutes in the cash market. Relatively high prices for deliverable, as compared to nondeliverable, financial instruments may be an indication of an attempt to remove deliverable supplies from the futures market as part of an attempted manipulation. Also, to the extent participants in the markets take positions vastly beyond their financial means or capacity to take delivery or make settlement, this may be a sign of manipulative activity.

Several financial products involve US Treasury or Agency instruments (e.g., bonds or notes). The CFTC surveillance staff, therefore, maintains open lines of communication with, among others, the US Treasury Department, the Federal Reserve Bank of New York, and the Securities and Exchange Commission.

Cash-settled markets. The size of a trader's position at the expiration of a cash-settled futures contract cannot affect the price of that contract because the trader cannot demand or make delivery of the underlying commodity. The surveillance emphasis in cash-settled contracts, therefore, focuses on the integrity of the cash price series used to settle the futures contract. Since manipulation of the cash market can yield a profit in the futures contract, CFTC staff monitor futures positions of significant size and are alert for unusual cash market activities on the part of large futures traders, especially in the period of time that the final cash price for futures settlement is determined.

Pertinent surveillance questions for those markets are:

- (i) as the futures contract expiration approaches, is the cash price moving in a manner consistent with supply and demand factors and/or with other comparable cash prices that are not used in the cash-settlement process?

Appendix 3: The CFTC Market Surveillance Program

- (ii) do traders with large positions in the expiring future have the capacity to affect the cash price series used to settle the futures contract?
- (iii) what information can be obtained from the organization that compiles the cash price series regarding how the price is determined for the period in question? Is anyone reporting prices that appear to be out of line with prices reported by others, and can it be determined if the party reporting those prices holds a futures position that would be affected favorably by those prices?

Special concerns related to equity futures. Generally, equities and derivatives markets likely will be closely linked through intermarket arbitrage. Therefore, effective surveillance of equity futures markets requires coordination among the exchanges trading the underlying equities and equity options to address intermarket trading abuses, such as manipulation, front running of customer orders and insider trading.

If the stock index underlying the futures and/or option contract is broad-based in terms of both the number and capitalization of the equities included in the index, intermarket price manipulation and insider trading (regarding information on individual stocks) concerns will be greatly reduced. Narrower indices and single-stock derivatives may require more aggressive surveillance and added protections with respect to misuse of information, especially to the extent that the market is, or acts like, a market in a single security. The CFTC cooperates with the Securities and Exchange Commission and encourages intermarket cooperation on surveillance issues.

Sources of Market Information

To accomplish its objectives, the CFTC market surveillance program uses many sources of daily market information. Some of this information is publicly available, including data on the overall supply, demand, and marketing of the underlying commodity; futures, option and cash prices; and data on trading volume and open contracts. Some of the information is highly confidential, including data from exchanges, intermediaries and large traders.

Appendix 3: The CFTC Market Surveillance Program

Exchanges report to the commission the daily positions and transactions of each clearing member. These data are transmitted electronically during the morning after the «as of» date. They show, separately for proprietary and customer accounts, the aggregate position and trading volume of each clearing member in each futures and option contract. These data are useful for quickly identifying the firms that clear the largest buy or sell volumes or hold the biggest positions in a particular market. The clearing member data, however, do not identify the beneficial owners of the positions.

To address this limitation, CFTC has at the heart of its market surveillance system a large-trader reporting system. Under this system, clearing members, futures commission merchants (FCM), and foreign brokers (collectively called reporting firm) electronically file daily reports with the CFTC. These reports contain the futures and option positions of traders that hold positions above specific reporting levels set by CFTC regulations—A list of current CFTC reporting levels can be found at the CFTC’s website. If, at the daily market close, a reporting firm has a trader with a position at or above the commission’s reporting level in any single futures month or option expiration, it reports that trader’s entire position in all futures and options expiration months in that commodity, regardless of size.

Since traders frequently carry futures positions through more than one FCM and since individuals sometimes control or have a financial interest in more than one account, the CFTC routinely collects information that enables its surveillance staff to aggregate related accounts. Reporting firms must file a CFTC Form 102 to identify each new account that acquires a reportable position. In addition, once an account reaches a reportable size, the account owner periodically is required to file a more detailed identification report, a CFTC Form 40, to further identify accounts and reveal any relationships that may exist with other accounts or traders.

To obtain more detailed and targeted information, CFTC may issue a “special call,” to a reporting trader or firm. The special call is designed to gain additional information on a participant’s trading and delivery activity, and may include the trader’s positions and transactions in the underlying commodity.

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Regulatory Response When Problems Develop

Surveillance economists prepare weekly summary reports for futures and option contracts that are approaching their critical expiration periods. Regional surveillance supervisors immediately review these reports. Surveillance staff advise the CFTC senior staff of potential problems and significant market developments at weekly surveillance meetings so that they will be prepared to take prompt action when necessary.

The market surveillance process is not conducted exclusively at the commission. Surveillance issues are usually handled jointly by the CFTC and the affected exchange. Relevant surveillance information is shared and, when appropriate, corrective actions are coordinated. Potential problem situations are jointly monitored and, if necessary, verbal contacts are made with the brokers or traders who are significant participants in the market in question. These contacts may be for the purpose of asking questions, confirming reported positions, alerting the brokers or traders as to the regulatory concern for the situation, or warning them to conduct their trading responsibly. This “jawboning” activity by the CFTC and the exchanges has been quite effective in resolving most potential problems at an early stage.

The CFTC customarily gives the exchange the first opportunity to resolve problems in its markets, either informally or through emergency action. If an exchange fails to take actions that CFTC deems appropriate, the commission has broad emergency powers under which it can order the exchange to take actions specified by CFTC. Such actions could include limiting trading to liquidating transactions, imposing or reducing limits on positions, requiring the liquidation of positions, extending a delivery period, or closing a market. Fortunately, most issues are resolved without the need to use the CFTC’s emergency powers. The fact that the commission has had to take emergency actions only four times in its history demonstrates its commitment to not intervene in markets unless all other efforts have been unsuccessful.

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Enforcement of Position Limits

The surveillance staff also monitors compliance with CFTC or exchange speculative-limit rules—see a separate backgrounder on *Speculative Limits, Hedging, and Aggregation in Commodity Futures and Options* available on the CFTC’s website. These rules help prevent traders from accumulating concentrations of contracts of a size sufficient to possibly disrupt a market. To monitor those limits, the market surveillance staff reviews daily large-trader reports for potential violations. Although bona fide hedgers are exempt from speculative limits, CFTC staff monitor hedgers’ compliance with their exemption levels. Commercial traders that carry futures and option positions in excess of CFTC speculative position limit levels are required to submit a monthly statement of cash positions. These statements show the total cash position of each trader, which reflects the amount of the trader’s actual physical ownership of each commodity and the amount of the trader’s fixed-price purchases and sales for which the trader has a legitimate cash risk. CFTC staff compares each trader’s cash position to the trader’s futures and option positions.

In summary, the CFTC has a comprehensive market surveillance program to detect and prevent corruption of the economic functions of the futures and option markets that it oversees.