proposal,[1] others took comfort in it.[2] Despite this ''don't ask, don't tell'' approach, DTFs all will be ''recognized'' by the Commission as regulated markets.[3] In turn, these DTF markets will hold themselves out to the public as markets regulated by the CFTC.

The Commission and certain commenters within the industry find the possible mix of futures and non-futures products on DTFs acceptable. They rely on Congressional report language from the 1992 legislation that, in effect, allows the Commission to exempt transactions without first determining that they are in the agency's jurisdiction.[4]

In the context of bilateral, privately negotiated transactions—such as those swaps the Commission was directed by Congress to ''promptly exempt—such an exemption makes a certain amount of sense. The consequence of any performance failure or fraud is borne solely by the parties to the transaction.

However, today the Commission extends this rationale to entities that are, in fact, exchange markets. Global participants and international regulators rely on our representations that these markets are regulated. I will not be comfortable making such representations with regard to DTFs where the Commission's jurisdiction is so questionable.

As a secondary matter, I am concerned with the level of oversight that will be applied to all DTF markets. Under the new framework, DTFs generally will not be required to maintain or provide the Commission with reports of futures positions held by their customers that exceed certain thresholds. In what appears to be a nod to the need for these reports, known as ''large trader reports,'' the Commission contemplates collecting this information only in a select, few markets. But the vast majority of markets trading at the DTF level—generally those without retail participants—will have no obligation or duty to the Commission or the public with regard to this important information.

Large trader reports are an essential tool in the Commission's effort to detect and deter market manipulations. Deterrence is important because the effects of market manipulations reach far beyond the market's participants. Consumers ultimately pay for manipulations in commodity markets: Home buyers pay higher interest rates; commuters pay higher prices for gasoline; and we all pay higher prices for heating oil and food. For these reasons, I would require large trader reports in all DTF markets, regardless of the type of commodity product or participant involved.

The Department of the Treasury identified this issue in its comment letter, stating that ''large trader reporting requirements have worked well in the market for treasury futures, both for the information they reveal to regulators and their deterrent effect.'' [5] I could not agree more strongly with the Treasury Department on this point. While it appears that large trader reporting will attach to government securities markets, I do not understand why the Treasury's views have not provided just as compelling a rationale for other markets which are not nearly as deep or liquid.

I believe that DTF markets may prove to be very successful, commercially. They may well grow to be the commercial markets where pricing and price-basing of commodities occurs. The Commission would be wise to retain its ability to detect and deter manipulations at their incipience.

Dated: November 20, 2000.

Thomas J. Erickson,

Commissioner.

[FR Doc. 00–30267 Filed 12–12–00; 8:45 am]

BILLING CODE 6351–01–P

[1] *See* Mercatus letter, Aug. 21, 2000, p. 4 (''While it may be appropriate for the CFTC to avoid such a determination in granting an exemption from regulation, it is not clear that the CFTC can exercise its antifraud authority in relation to a particular transaction without determining that the CFTC is authorized to exercise jurisdiction in the first instance.'') The drafters of the Mercatus letter further note that the ''broad definition of MTEF'' in the proposed rules could even be read ''to cover auction markets such as eBay and all other forms of B2B trading facilities, whether electronic or not.'' *Id.* at 5. The Commission attempts to deflect this criticism in the final rules, stating that ''so long as a facility auctions instruments outside of the Commission's regulatory jurisdiction under the Act, [the] exemptions therefrom and this framework would have no application to its business.'' *See* Final Rules for a New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations, pp. 13–14. The Commission's response misses the rudimentary point that it will be anyone's guess whether some instruments possibly traded on DTFs are within or outside the Commission's jurisdiction.

[2] *See* Lehman Brothers letter, Sept. 5, 2000, p. 2 (''[T]he Commission's jurisdiction extends solely to futures and commodity options, such that reserving anti-fraud and anti-manipulation authority over futures and commodity options merely restates the current state of law. Such a reservation of authority cannot, legally, extend to transactions other than futures and commodity options and repeating the nature of the agency's statutory jurisdiction carries no legal baggage.'')

[3] The only apparent penalty for refusing to comply with Commission rules is the market's loss of recognition as a DTF. I am not comfortable with this after-the-fallout remedy, and I cannot imagine potential market participants or domestic or international regulators being any more pleased.

[4] *See* A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations, p. 11, citing H.R. Rep. No. 978, 102d Cong., 2d Sess. 82–83 (1992).

[5] *See* Department of Treasury letter, Aug. 16, 2000, p. 4.

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 1, 3, 4, 140, 155 and 166

RIN 3038–AB56

Rules Relating to Intermediaries of Commodity Interest Transactions

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rules.

SUMMARY: As part of a comprehensive regulatory reform process, the Commodity Futures Trading Commission (CFTC or Commission) has revised its rules relating to intermediation of commodity futures and commodity options (commodity interest) transactions. These new rules and rule amendments will provide greater flexibility in several areas. For example, to ease barriers to entry for persons seeking registration as futures commission merchants (FCMs) or introducing brokers (IBs), the Commission has established a simplified registration procedure for those persons who are regulated by other federal financial regulatory agencies and who limit their customer base to institutional customers only, regardless of the type of market involved.

With respect to trading on recognized derivatives transaction facilities (DTFs), the Commission has determined to permit non-institutional customers to enter into transactions thereon, provided that such non-institutional customer business is transacted either through a registered FCM that is a clearing member of at least one designated contract market or recognized futures exchange (RFE), and that has adjusted net capital of at least $20 million or by a registered commodity trading advisor (CTA) who has discretionary authority over the non-institutional customer's account, and who has assets under management of not less than $25 million. The latter circumstance is an expansion of the proposal.

As proposed, the Commission is expanding the range of instruments in which FCMs may invest customer funds. In response to various comments concerning the expansion of permissible investments, the Commission is making certain adjustments to the proposals relating to, among other things, concentration limits as applied to securities held in connection with repurchase transactions, permissible investments in FCMs and their affiliates by money market mutual funds meeting the requirements of Rule 2a–7 under the Investment Company Act of 1940 (Investment Company Act), and investment in foreign sovereign debt. Separately, the Commission also is considering proposing risk-based capital rules for FCMs. Further, the Commission recently adopted a revised interpretation concerning the treatment of customer funds on deposit with

FCMs for the purpose of trading on foreign markets under Rule 30.7.[1]

In addition, the Commission is announcing herein the adoption of other new rules and rule amendments, concerning the definition of the term ''principal,'' certified financial reports, ethics training, disclosure, account opening procedures, trading standards, reporting requirements, and offsetting positions, as proposed. The Commission has made additional changes to allow a registrant to notify the Commission when a new natural person is added as a principal ''promptly'' after the change occurs. With respect to pre-dispute arbitration agreements between an institutional customer and a Commission registrant, the Commission has determined to allow such parties to negotiate any or all terms of the agreement, provided that the signing of such agreement by the institutional customer cannot be made a condition of doing business with the registrant. The Commission has also determined to allow any counterclaim to be heard as part of an arbitration proceeding between a non-institutional customer and a registrant where the parties have agreed in advance that all such claims must be included in the proceeding, provided that the aggregate value of the counterclaim is capable of calculation and that the counterclaim arises out of a transaction subject to Commission jurisdiction.

EFFECTIVE DATE: February 12, 2001.

FOR FURTHER INFORMATION CONTACT:
Lawrence B. Patent, Associate Chief Counsel, Paul H. Bjarnason, Jr., Special Advisor for Accounting Policy (with respect to Rule 1.25 concerning investment of customer funds), or Ky Tran-Trong, Attorney-Advisor, Division of Trading and Markets, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, D.C. 20581. Telephone: (202) 418–5450.

SUPPLEMENTARY INFORMATION:

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I. Introduction

A. Background

In accordance with the recommendations made in a staff task force report submitted to the Commission's Congressional oversight committees on February 22, 2000, the Commission on June 22, 2000 published a proposed new regulatory structure intended to adapt to the changing needs of the modern marketplace (New Regulatory Framework).[2] In reviewing its regulatory structure for intermediaries, the Commission in its proposal (Proposing Release) identified eight Core Principles that it believes are fundamental to assuring proper conduct by intermediaries of commodity interest transactions.[3] Although the Commission did not propose these Core Principles as rules, they guided the Commission in its regulatory reform efforts, as the Commission reviewed all of its rules related to intermediaries in light of the Core Principles. The Commission proposed reforms contemplating greater flexibility for intermediaries and their customers via a regulatory structure that acknowledges the different levels of safeguards appropriate to the types of instruments, customers, and markets involved.

To the extent that an existing rule was not addressed in the Proposing Release, and no amendment thereto has been adopted, the rule will apply to intermediaries transacting business on behalf of customers on contract markets, RFEs and DTFs. When an intermediary transacts business on an exempt multilateral transaction execution facility (exempt MTEF), these transactions are subject only to the Commission's antifraud and antimanipulation authority to the extent applicable.[4] Similarly, where a DTF permits trading only on a principal-to-principal basis, CFTC rules related only to intermediaries will not be applicable to such a market structure.[5]

The Core Principles that guided the Commission in its review of rules applicable to intermediaries, which relate to registration, fitness of registrants, financial requirements, risk disclosure, trading standards, supervision of personnel, large position reporting requirements, and recordkeeping, are as follows:

1. Registration Required

Any person or entity intermediating a transaction on an RFE, or on a DTF that permits intermediation of trading, must be registered in the appropriate capacity with the Commission as an FCM, IB, CTA, commodity pool operator (CPO), associated person (AP) of any of the foregoing, or floor broker (FB). In addition, a person trading solely for his or her own account on an RFE or DTF with a trading floor must register as a floor trader (FT).

2. Fitness of Registrants

Intermediaries and FTs in all markets recognized by the CFTC must be and remain fit.

3. Financial

FCMs must keep and safeguard customer money and FCMs and IBs must have sufficient capital to ensure their capacity to meet their obligations to customers.

4. Risk Disclosure

Intermediaries must provide to customers risk disclosure appropriate to the particular instrument or transaction and the customer.

5. Trading Standards

Intermediaries and their affiliated persons are prohibited from misusing knowledge of their customers' orders.

6. Supervision

All intermediaries, including APs having supervisory responsibilities, must diligently supervise all commodity interest accounts that they carry,

[1] 65 FR 60558 (Oct. 11, 2000). Unless otherwise noted, Commission rules referred to herein are found at 17 CFR Ch. I (2000).

[2] *See* A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations, 65 FR 38986; Rules Relating to Intermediaries of Commodity Interest Transactions, 65 FR 39008; A New Regulatory Framework for Clearing Organizations, 65 FR 39027; Exemption for Bilateral Transactions, 65 FR 39033.

[3] 65 FR 39008.

[4] *See id.* at 39009 nn.1–3.

[5] *See id.* A more complete description of the various new market structures can be found in ''A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations,'' published elsewhere in today's edition of the **Federal Register.**

operate, advise, introduce, handle, or trade, as well as all of the other activities that arise in their business as intermediaries. All intermediaries must establish, maintain, and enforce supervisory procedures.

7. Reporting of Positions

All intermediaries must report to the Commission, RFE or DTF information that permits the Commission, RFE, or DTF to identify concentrations of positions and market composition. Reports of transactions on RFEs are required on a routine and non-routine basis, as is the case for transactions on contract markets. Reports of transactions on an institutional-participant DTF are required only on a non-routine basis.[6]

8. Recordkeeping

All intermediaries (and FTs) must keep full books and records of all activities related to their business as an FCM, IB, CPO, CTA, FB, or FT, in a form and manner acceptable to the Commission for a period of five years. Such information must be readily available during the first two years and be produced to the Commission at the expense of the person required to keep the books or records. All such books and records shall be open to inspection by any representative of the Commission or the U.S. Department of Justice.

Certain of the Commission's rule amendments, such as those concerning ethics training and the definition of the term ''principal,'' will affect all registered firms. The other new rules and rule amendments will affect mainly FCMs and IBs, and are not applicable to CPOs and CTAs. The Commission intends to consider further rulemaking proposals at a subsequent date that will focus more directly upon Part 4 of the Commission's rules, which governs the operations and activities of CPOs and CTAs.[7]

B. The Comments Received

The Commission received 81 comment letters on the New Regulatory Framework, 51 of which were posted to the comment file on intermediaries on the Commission's web site. Of those 51 comment letters, 31 letters addressed specific provisions of the Proposing Release: five from U.S. commodity exchanges; two from the National Futures Association (NFA); one from the Futures Industry Association (FIA); six from other futures industry professional associations; one from the Federal Reserve Bank of Chicago (FRBC); one from the Department of the Treasury (Treasury); one from a provider of ethics training programs for the futures industry; five from firms registered as FCMs; one from a margin settlement bank for various U.S. exchanges and clearing corporations; three from trade associations representing the grain industry; one from a group of trade associations representing various producer groups; two from public policy centers; one from a single firm registered as an FCM, CPO and CTA; and one from a certified public accounting firm. These commenters, as well as those that addressed the concept of regulatory reform in a more general fashion, expressed strong support for the Proposing Release, but some suggested that the relief did not go far enough towards replacing the Commission's regulatory framework concerning intermediaries with core principles.[8]

The Commission has carefully reviewed all of the comments received. Based upon this review, the Commission generally has determined to adopt the new rules and amendments as proposed in the Proposing Release. In response to the comments, the Commission has also decided, however, to modify the proposal in several respects. First, the Commission has determined to expand the ''passport'' provisions with respect to those FCMs and IBs that are already registered with the Securities and Exchange Commission (SEC) in a similar registration capacity, or that are authorized to perform these functions by a federal banking authority. As adopted, these rules will allow those FCMs and IBs to follow a simplified registration procedure in order to conduct business solely for institutional customers on designated contract markets and RFEs, in addition to DTFs. Second, the Commission has determined to permit certain CTAs to place trades on a DTF on behalf of non-institutional customers, provided that the non-institutional customer's investment decisions are directed by the CTA and that total assets over which the CTA has discretionary authority are not less than $25 million. The proposal would have required non-institutional customers wishing to trade on DTFs to transact their business only through an FCM with at least $20 million in adjusted net capital that is also a clearing member of at least one designated contract market or RFE.[9] Third, the Commission has made adjustments to its rules governing permissible investments for customer funds in response to the comments received. Fourth, the Commission has adopted additional changes to allow a registrant to notify the Commission ''promptly'' after a new principal is added, rather than prior to the change as was the case previously. Fifth, with respect to pre-dispute arbitration agreements between an institutional customer and a Commission registrant, the Commission has determined to allow such parties to negotiate any or all terms of such agreements, provided that the signing of the agreement may not be made a condition of doing business with the registrant. Sixth, the Commission has decided to permit any counterclaim arising out of a transaction subject to the Commodity Exchange Act (Act) or regulations thereunder to be heard as part of an arbitration proceeding between a non-institutional customer and a registrant where the parties have agreed in advance that all such claims must be included in the proceeding.

In the Proposing Release, the Commission gave a detailed explanation for each revision that it proposed to

[6] As discussed in a companion release in today's edition of the **Federal Register**, large trader reports will not be required from participants trading on a DTF restricted to commercial participants, except where the Commission specifically orders otherwise.

[7] The Commission wishes to make clear that its regulatory reform efforts are an ongoing process. Thus, for example, as a part of the regulatory reform process, the Division of Trading and Markets recently permitted designated self-regulatory organizations (DSROs) to conduct ''risk-based'' auditing and thereby take into account a firm's business practices in establishing the scope and timing of audits. *See* Financial and Segregation Interpretation No. 4–2, CFTC Staff Letter 99–32, [1998–1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,745 (Aug. 20, 1999). Similarly, the Commission is considering amendments to the minimum capital requirements for FCMs. Those proposed amendments would contain an approach, generally referred to as ''risk-based'' capital requirements, that is based more upon position risk than is the case under the current rules.

[8] Commenters are generally identified by name below when their comments are discussed. Citations to comment letters are denoted as ''CL 22–x.'' The number 22 represents the comment file for the Proposing Release and ''x'' is the number assigned to a particular comment letter as set forth on the Commission's website, www.cftc.gov.

[9] As explained in the separate release on ''A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations'' in today's edition of the **Federal Register**, however, the Commission is amending its proposal to permit a non-institutional customer to enter an order directly to a DTF's electronic trading platform where the customer's account is carried by a registered FCM with at least $20 million in adjusted net capital that is also a clearing member of at least one designated contract market or RFE, provided that such FCM's credit filter is maintained as part of the DTF's electronic trading platform. *See* § 37.2(a)(2)(ii)(A).

In addition, FTs and FBs will be permitted to trade for their own account on a DTF, even if they would not otherwise come within the definition of an institutional customer, provided that their obligations in connection with their trading on the DTF are guaranteed by an FCM. *See* § 37.1(b)(1), (2). Generally, an FT or an FB must have total assets exceeding $10,000,000 to be considered an institutional customer. *See* §§ 1.3(g), 35.2(b)(10), (11).

make to the rules relating to intermediation of commodity interest transactions. The scope of this **Federal Register** release generally is restricted to the comments received on the Proposing Release and changes to the proposed new rules and rule amendments that the Commission has made in response thereto. Accordingly, the Commission encourages interested persons to read the Proposing Release for a discussion of the background and purpose of each of the rule amendments that is not described in detail in this **Federal Register** release.

The Proposing Release also presented several sets of questions intended to elicit public comments on various issues. For instance, the Commission requested comment concerning the need to update and to make more flexible its minimum net capital requirements for FCMs by permitting the application of risk-based net capital requirements.[10] In response to the comments received, the Commission plans to separately propose various rules and amendments addressing risk-based capital requirements. The Commission also posed certain questions related to the treatment of customer funds.[11] Reactions were mixed regarding these additional issues. Consequently, the Commission will continue to study these issues.

II. Responses to the Comments Received

A. General

As noted above, several commenters urged the Commission to revoke many of the rules that govern the relationship between futures and options customers and intermediaries, and to adopt in their place a set of core principles and statements of acceptable practices that reflect the ''largely institutional nature of derivatives market participants.'' (CL 22–31 at 2–3; see also CL 22–22 at 9; CL 22–24 at 1; CL 22–39 at 8; CL 22–35 at 11) In particular, FIA commented that:

> [We have] identified the following core principles that we believe should govern intermediaries in the conduct of their business, without regard to the market on which a transaction is executed: (1) Registration of intermediaries and their associated persons; (2) minimum financial requirements; (3) protection of customer funds appropriate to the type of customer; (4) prohibition against fraud and manipulation; (5) large trader reporting requirements; and (6) recordkeeping. These core principles, combined with an effective self-regulatory organization audit program to assure that intermediaries have developed and are enforcing adequate internal controls[,] should achieve the Commission's regulatory purpose. (CL 22–31 at 3 (footnotes omitted))

In general, the Commission believes that it is more expeditious at this time to adopt the specific regulatory reforms contemplated in the original release. Replacing the current rules with core principles might have delayed these changes, and in some instances, resulted in no practical benefit to the regulated community. To use Rule 1.55 as an example, the development of a core principle approach in this area would have required the Commission to propose the repeal of Rule 1.55 and the adoption of a core principle for disclosure together with a Statement of Acceptable Practices. The Statement of Acceptable Practices would likely provide, as the rule does now, no standard disclosure requirement for institutional customers and the basic single-page statement now applicable to non-institutional customers. At the end of this process, there would be no discernible change in FCM or IB operations. Firms might theoretically be freer to develop their own statements, but to clear them through counsel and self-regulatory organization (SRO) staff would likely be costly and time-consuming. Accordingly, the Commission did not believe that it would be an effective use of the Commission's or the industry's resources at this time to replace Rule 1.55 solely for the purpose of establishing a core principle concerning disclosure. The Commission reaches similar conclusions with respect to the repeal of other rules.

Second, the Commission believes that certain issues, such as the computation of capital for a financial intermediary, do not lend themselves easily to a core principle approach. As one commenter observed: ''Capital and segregation requirements * * *'' must be spelled out in detail to ensure the integrity of customer funds.'' (CL 22–24 at 1)

Third, as the New York Mercantile Exchange (NYMEX) noted, a re-examination of the Commission's rules applicable to intermediaries with a goal towards replacing them with a set of Core Principles and statements of acceptable practices ''would require an intensive review of the applicable rules in this area,'' and accordingly, ''undertaking such an examination as part of the current Reform Proposal could so greatly lengthen the process as to undermine the entire reform effort.'' (CL 22–32 at 16–17)

Nevertheless, the Commission's decision at this time not to use a core principles approach with respect to intermediaries will not affect its commitment to the continued review of the rules affecting intermediaries to determine where core principles are appropriate.[12] In this regard, the Commission notes the request it made in the Proposing Release for specific comments concerning existing rules and suggested modifications thereto.[13] The Commission further notes that under Rule 140.99, there remains a procedure in place whereby the Commission's staff may consider specific individual circumstances and, where warranted, the Commission's staff may grant interpretative, exemptive, or no-action relief from requirements under the Act or Commission rules to individuals or entities requesting such relief.

Certain commenters specifically addressed the need for further regulatory relief with respect to CPOs and CTAs. (CL 22–22 at 9; CL 22–43 at 5–6; CL 22–47 at 2) The Commission recognizes that CPOs and CTAs represent ''important sectors of the futures industry.'' (CL 22–22 at 2) As stated above, the regulatory reform process is an ongoing one. The Commission continues to explore additional areas in which relief for CPOs and CTAs may be warranted, *e.g.,* Part 4 of the Commission's rules, and will be making further rulemaking proposals.

With specific regard to recordkeeping, the Commission in 1999 adopted amendments to the recordkeeping requirements of Rule 1.31 in order to allow recordkeepers to store most records on either micrographic or electronic storage media for the full five-year period, thereby harmonizing procedures for those firms regulated by both the Commission and the SEC.[14] In order to avoid undue hardship, the Commission later extended the effective date of the requirement that recordkeepers using only electronic storage media enter into arrangements with third-party technical consultants.[15] The Commission's staff is continuing to work with industry representatives to implement this procedure.

[10] 65 FR at 39012.

[11] *Id.* at 39014–15.

[12] Should the Commission in the future adopt core principles in the place of some of its existing regulations as they pertain to intermediaries, NFA urged the Commission to look to NFA and the industry to develop the acceptable practices for satisfying many of these core principles, subject to Commission approval. (CL 22–24 at 2) The Commission notes that it has already taken such an approach in certain areas, *e.g.,* disclosure to non-institutional customers trading on DTFs, and looks forward to continuing to work with NFA and the industry in developing acceptable practices in additional areas.

[13] 65 FR at 39009.

[14] 64 FR 28735 (May 27, 1999).

[15] 64 FR 36568 (July 7, 1999).

B. Core Principle One: Registration

1. Definition of the Term ''Principal''

Under Commission staff's prior interpretation of the definition of the term ''principal'' in Rules 3.1(a)(1) and 4.10(e)(1),[16] all officers of a registrant were treated as principals and required to register as such. In response to changes in management structures over the last 20 years and requests from registrants that certain employees, such as some vice presidents, not be considered principals because they do not exercise a controlling influence over the registrant or any of its activities subject to Commission regulation, the Commission proposed to amend Rules 3.1(a)(1) and 4.10(e)(1) by defining as principals persons within a given organizational structure who hold specific offices.[17] A registrant would, therefore, no longer be required to treat every officer as a principal, but only those who met the criteria of the rule as revised.

Commenters were strongly in support of the proposal to amend the definition of ''principal'' to reduce the number of persons required to be registered, and the Commission is adopting the amendments as proposed.[18] (CL 22–22 at 11; CL 22–24 at 3; CL 22–25 at 2; CL 22–31 at 13; CL 22–32 at 16) The Managed Funds Association (MFA) asked the Commission to confirm that the reference in the proposed amendment to the ''principal'' definition to ''any person in charge of a business unit subject to regulation by the Commission'' applied solely to ''the aggregate business unit acting in a registered capacity and not subsidiary divisions or units such as marketing, human resources, audit, and other departments within an operating entity.'' (CL 22–22 at 11) The Commission agrees with this interpretation, and reiterates that the intent of the amended ''principal'' definition is to reduce the number of officers that will be considered principals, while ensuring that appropriate personnel, *e.g.,* those that exercise, or are in a position to exercise, ''a controlling influence over the registrant or any of its activities subject to Commission regulation,'' [19] remain listed as such.

The Commission also has determined to adopt, as proposed, conforming changes to Rules 4.24(f)(1)(v), 4.25(a)(8)(ii)(A) and 4.25(c)(2)(i)(B), applicable to CPOs, and 4.34(f)(1)(ii) and 4.35(a)(7)(ii)(A), applicable to CTAs, as incorporated by reference in amended Rule 4.10(e)(1). Accordingly, CPOs and CTAs will only be required to provide business backgrounds and proprietary trading results for those principals who participate in making trading or operational decisions, or supervise persons so engaged, and not all officers.[20]

In response to suggestions by FIA, the Commission has determined to delete Rule 3.32, which specifies certain events or changes within a firm's management structure that require the firm to file a new registration form. (CL 22–31 at 13–14) The Commission is adding a new paragraph (a)(2) to Rule 3.31 to require the registrant to file a Form 8–R on behalf of each new natural person principal who was not listed on the registrant's Form 7–R ''promptly'' after the change occurs. Rule 3.31(a)(2) was drafted to closely parallel Rule 3.10(a)(2)(i), and provides that, if the change that renders the application for registration deficient or inaccurate results from the addition of a new principal without a current Form 8–R on file with NFA, a Form 8–R for that principal must accompany the Form 3–R amending the registrant's application for registration.[21]

2. Special Procedures Available to Firms Subject to Securities or Banking Regulation

The Commission proposed to amend Rule 3.10 to simplify the registration process for FCMs or IBs who conduct business solely for institutional customers on a DTF, and who are already registered with the SEC in a similar registration category or who are authorized to perform these functions by a federal banking authority.[22] The Commission stated in the Proposing Release that such applicants would be registered as an FCM or IB upon filing notice with NFA of their intent to undertake such limited activities, together with a certification that they are registered or authorized to engage in a similar function by, and are in good standing with, the SEC or a federal banking authority. In addition, individuals acting in the capacity of APs for such FCMs or IBs need not be registered or listed, and would not be subject to proficiency testing or ethics training requirements. These firms and their salespersons would remain subject to antifraud provisions, however.[23]

The Chicago Mercantile Exchange (CME), along with other commenters, stated that the ''passporting'' provisions did not go far enough and urged the Commission to extend the provisions to allow those persons who are regulated by the SEC or a federal banking agency, and who opt to register as an FCM or IB under the simplified registration procedure, to conduct business for institutional customers on all trading platforms, rather than limit their access to DTFs.[24] (CL 22–35 at 12; *see also* CL 22–24 at 3–4; CL 22–25 at 2–3) In support of this recommendation, the Chicago Board of Trade (CBT) stated, ''[i]f the nature of the entity or individual intermediating the transaction and the nature of the customer determines the need for any particular requirement, whether the transaction facility is a DTF or an RFE is irrelevant.'' (CL 22–25 at 3; *see also* CL 22–35 at 15)

In contrast, however, the National Introducing Brokers Association (NIBA) urged that any person or organization conducting any commodity interest business should be subject to full registration requirements (CL 22–17 at 4), while MFA stated that firms making use of the ''passport'' procedure should be subject to a limitation upon their commodity interest business, such as a requirement that their commodity interest activities be incidental to their primary business as a broker-dealer or bank. (CL 22–22 at 11–12)

Upon consideration of the comments received, the Commission agrees that given the nature of the customers (*i.e.,* solely institutional customers) for whom a securities broker-dealer or bank would

[16] Rule 3.1(a) defines ''principal'' for purposes of the Commission's Part 3 rules, which govern registration. Rule 4.10(e) defines ''principal'' for purposes of the Commission's Part 4 rules, which apply to the activities of CPOs and CTAs.

[17] 65 FR at 39010.

[18] As amended, the ''principal'' definition will continue to include all directors of a corporate registrant. In addition, the definition will include the general provision that defines as a principal any person occupying a similar status or performing similar functions to those persons specifically listed, having the power, directly or indirectly, through agreement or otherwise, to exercise a controlling influence over a firm's activities that are subject to regulation by the Commission. As noted in the Proposing Release, what constitutes ''a controlling influence'' will be left for determination on ''a case-by-case basis.'' *Id.* at 39011 n.11.

[19] *Id.* at 39010.

[20] *Id.* at 39011.

[21] An additional conforming change was made to § 3.21(c) to reflect the deletion of § 3.32, and the addition of new paragraph (a)(2) to § 3.31.

[22] 65 FR at 39011–12.

[23] *Id.* at 39012.

[24] In this regard, the CME stated that given the restrictions of the DTF market structure:

The proposed rulemaking provides no relief whatsoever to a securities broker-dealer (not also registered as a FCM) that wishes to execute transactions in both stock index futures and the underlying stocks in order to implement an asset allocation strategy for its institutional customers. So long as the customers are sophisticated institutions, we can see no regulatory reason not to allow them to use the federally-regulated intermediary of their choice in effecting transactions in a futures market, regardless of whether the market is regulated as a designated contract market, an RFE, a DTF or an exempt MTEF. (CL 22–35 at 12) be acting as an FCM or IB, the securities broker-dealer or bank should be eligible for the simplified FCM or IB registration procedures, irrespective of the type of exchange on which the customer seeks to conduct its transactions. Accordingly, the Commission has adopted Rule 3.10(a)(1)(i)(B) to permit an individual or entity who is registered with the SEC as a broker-dealer, or has been authorized by the appropriate banking authority, to register as an FCM or IB simply by filing notice with NFA, together with a certification of registration with the appropriate financial regulator.[25] Such FCMs and IBs who are otherwise regulated by another federal financial regulator will be permitted to conduct business solely for institutional customers on any designated contract market, RFE or DTF.[26] The Commission notes, however, in accordance with FIA's comments, that the simplified registration procedure is limited to banks themselves, and not to their affiliates, and further, that once registered, securities broker-dealers and banks would be subject to the same rules that govern all FCMs and IBs. (CL 22–34 at 13)

Although ''passported'' firms will be eligible for the simplified FCM or IB registration procedures without regard to the type of exchange on which their institutional customers seek to conduct business, the Commission has determined to adopt Rules 1.17(a)(2)(iii) and 1.52(m), as proposed, without making further changes. Under Rule 1.17(a)(2)(iii), the Commission would not require an FCM or IB registered under the ''passporting'' procedures in Rule 3.10(a)(1)(i)(B) to meet the Commission's minimum financial requirements if (i) it meets the appropriate net capital requirements of its primary regulator, (ii) its activities are limited to serving institutional customers trading on DTFs that do not require compliance with CFTC minimum financial requirements for such ''passported'' firms, and (iii) it conforms to minimum financial standards and related reporting requirements set by such DTF in its bylaws, rules, regulations or resolutions.[27]

If, however, the ''passported'' FCM or IB chooses to conduct transactions on behalf of its institutional customers on a contract market or RFE in addition to its DTF activities, the firm would then be required to satisfy the Commission's minimum financial requirements. The Commission believes that this requirement is important to protect the financial integrity of these markets because a customer default may have ancillary impacts not just on other customers of the affected firm, but also on other firms and their customers transacting business on such markets. Moreover, because the Commission anticipates that ''passported'' firms will conduct most of their business in the securities or banking fields, with only a minor portion of their activities involving commodity interests, the requirement that such firms meet the Commission's minimum financial requirements if they conduct business for their institutional customers on a contract market or RFE should not impose a significant burden. Rules 1.17(a)(1)(i) and (ii) already require the dually registered FCM or IB to meet the greater of either the Commission's or SEC's minimum financial requirements, and in most cases, those entities that conduct most of their business in the securities or banking fields will have satisfied the Commission's minimum financial requirements by meeting the SEC capital requirements. Similarly, the Commission allows a dually registered FCM or IB to satisfy the basic financial reporting requirements of Rule 1.10 by filing a copy of its FOCUS report in lieu of a Form 1–FR. In addition, Rule 1.52(m) is adopted as proposed to relieve a DTF from the requirement that it adopt for ''passported'' firms, the Commission's minimum adjusted net capital standards.[28]

The Commission continues to encourage the SEC to consider reciprocal amendments to its rules to accommodate FCMs and IBs that are not now dually registered as securities brokers or dealers, but that may wish to act as intermediaries in the securities markets.

The Commission also noted in the Proposing Release that it was considering updating and making more flexible its minimum net capital requirements with respect to FCMs, specifically with respect to adopting risk-based net capital requirements.[29] Commenters were overwhelmingly in favor of this proposal, and the CBT further noted that it had, along with the Board of Trade Clearing Corporation (BOTCC) and the CME, already adopted risk-based capital requirements at the clearing organization level. (CL 22–25 at 3) The Commission is separately considering proposing rules related to risk-based net capital requirements.[30]

3. Standard Application Procedures for FCMs and IBs

The Commission proposed that applicants for registration as FCMs or IBs who raise their own capital to satisfy minimum financial requirements would be permitted to file an unaudited financial report indicating satisfaction of the minimum requirements, rather than be required to provide certified financial statements with their registration application.[31] A firm taking

[25] As noted in the Proposing Release, a firm acting in the capacity of an FCM would be required to become a member of a registered futures association. *See* § 170.15. NFA is currently the only registered futures association. NFA Bylaw 1101 essentially provides that no NFA member may deal with another person with respect to an account, order or transaction where the other person is acting in a capacity that requires registration, unless that other person is also a member of a registered futures association. The combination of Commission Rule 170.15 and NFA Bylaw 1101 therefore requires most registrants to become members of NFA.

The Commission may consider not requiring NFA membership in the future if reciprocal arrangements were made by the primary regulators of other financial industry segments to recognize CFTC registration without requiring corresponding SRO membership.

[26] Because an intermediary that conducts business on an exempt MTEF will not be subject to Commission regulation for activity on the exempt MTEF, except for the antifraud and antimanipulation provisions of the Act to the extent applicable, it is unnecessary to extend the ''passporting'' procedure to firms trading on these markets.

[27] 65 FR at 39012.

[28] *Id.*

[29] *Id.*

[30] Although the Proposing Release did not generally address registration procedures for firms that are dually registered with the National Association of Securities Dealers (NASD) and NFA, the Association of Registration Management (ARM) made several suggestions in that area. Among its comments, ARM recommended that: (1) Firms that are dually registered with NASD and NFA should be permitted to maintain internal records about branch office location and supervision of those locations; (2) NFA should be permitted to rely on the fingerprint information available through the NASD's Internet-based Central Registration Depository (Web CRD) database for dual registrants; and (3) NFA also should be permitted to rely on disciplinary and disclosure information filed through amendments to Web CRD. (CL 22–23 at 2–3) ARM also recommended that the Commission eliminate its Form 7–R annual update requirement by allowing NFA to rely upon, and to record changes in a registrant's application through use of, the amendments filed via Form 3–R throughout the year. (CL 22–23 at 1–2)

The Commission's Registration Working Group (RWG) will consider ARM's suggestions in the near future. In this regard, Commission staff indicated in a letter dated July 13, 2000 to NFA that: (1) NFA could rely upon reporting by the futures industry SROs and the Commission with respect to SRO disciplinary actions and Commission enforcement actions; (2) certain requirements related to the collection of employment, residential and educational data could be reduced; and (3) as part of the annual update process, firms would only be required to report any new criminal or civil matters that had arisen since the previous update.

[31] *Id.* However, as stated in the Proposing Release, those IB applicants who do not raise their own capital continue to be required to file a guarantee agreement entered into with an FCM with their registration application. IBs and FCMs should refer to Commission Rules 1.10(j) and 1.57(a)(1) concerning the procedures applicable to guarantee

advantage of the new procedure would be subject to an on-site review within six months of registration by the firm's DSRO or, at the DSRO's discretion, a conference between appropriate staff of the firm and the DSRO at the DSRO's offices. An applicant that did not wish to be subject to the six-month review could continue to follow the existing rules and file a certified financial statement with its application.[32]

In general, commenters supported the proposed elimination of the certified financial statement requirement for IB applicants. (CL 22–17 at 3; CL 22–24 at 4; CL 22–25 at 4) Both NFA and the CBT, however, expressed reservations about eliminating the requirement for FCM applicants. (CL 22–24 at 4; CL 22–25 at 4) In addition, NFA recommended that the Commission consider allowing the DSRO to conduct the six-month review of independent IBs telephonically where the DSRO has no reason to be concerned about the IB's capital. (CL 22–24 at 4) The CBT expressed the view that the six-month time period for the on-site review of the FCM by the DSRO should be calculated from the date the FCM begins customer business, rather than six months from the date of registration. (CL 22–25 at 4).

The Commission has determined to eliminate the requirement to file certified financial statements with FCM or IB registration applications by adopting Rules 1.10 (a)(2)(i)(C) and (a)(2)(ii)(C), generally as proposed.[33] This alternative procedure is modeled on similar procedures in the securities industry. Although the Commission is not requiring FCMs to file a certified financial statement with their application for registration, this does not preclude any SRO from imposing this requirement before accepting an FCM for membership. With respect to the six-month review that must be conducted should an FCM or IB choose not to file a certified financial statement with its registration application, the Commission does not object, in the case of an IB, to allowing the DSRO to conduct the review telephonically where the DSRO does not have reason to question the IB's capital. However, the Commission believes that the six-month time period for the review of both FCMs and IBs should begin from the date the applicant is registered. The Commission has held consistently that once a registrant becomes registered in a certain capacity, the registrant is immediately assumed to be engaging in the activities permitted by such registration.[34]

C. Core Principles Two and Six: Fitness and Supervision

The Commission proposed to delete Rule 3.34 and instead to implement Congressional intent regarding ethics training through a Statement of Acceptable Practices.[35] Rule 3.34 specified frequency and duration of ethics training, the suggested curriculum, qualifications of instructors, and the necessary proof of attendance at such classes. In proposing to replace the rule with a Statement of Acceptable Practices that would leave the format, frequency, and providers of ethics training up to the registrants themselves, the Commission expressed its belief that greater flexibility regarding ethics training and proficiency testing could be afforded to registrants than was permitted under Rule 3.34. For registrants seeking guidance as to the maintenance of proper ethics training procedures consistent with the purposes of the Core Principle that intermediaries must be and remain fit, the Commission stated that the Statement of Acceptable Practices could function as a ''safe harbor.''[36]

In general, commenters expressed strong support for the Commission's proposal, stating, for example, that Rule 3.34 had become ''far too detailed and administratively cumbersome,'' (CL 22–24 at 5) and that ''each registrant should be responsible for implementing an ethics training program that addresses the registrant's business activities.'' (CL 22–31 at 14) Other commenters, however, expressed their beliefs that Rule 3.34 already provided sufficient flexibility to registrants, and that by eliminating the rule, the Commission risks sending the wrong message to the industry regarding the importance the Commission assigns to the ethics requirement. (CL 22–7 at 3; CL 22–43 at 6).

Upon consideration of the comments received, the Commission is deleting Rule 3.34 and issuing the Statement of Acceptable Practices as a new Appendix B to Part 3 of its Rules as proposed. Although the Commission notes the concern that eliminating Rule 3.34 may lead firms to place an inadequate priority on ethics training, the Commission does not believe that the replacement of the rule with a Statement of Acceptable Practices will diminish a registrant's obligations to remain fit and to adequately supervise the handling of customer accounts. Instead, the Commission hopes that the Statement of Acceptable Practices, which allows registrants to adopt ethics training programs that are better tailored to their needs, will help to imbue firms with a ''culture of ethics'' that is ongoing rather than episodic. The Commission believes that the essence of the ethics training or continuing education requirement is to remain current as to the legal requirements applicable to a person's role in the futures industry, which a registrant ignores at his or her peril.

The Commission also proposed to publish its recent ''guidance letters'' issued to NFA concerning the treatment of SRO disciplinary actions in assessing the fitness of FBs and FTs. The guidance letters were issued to provide greater clarity in interpreting the ''other good cause'' ground for statutory disqualification from registration under Section 8a(3)(M) of the Act. Support was expressed for this proposal and, accordingly, the Commission is hereby publishing both letters as an addition to Appendix A to Part 3 of its Rules.[37] (CL 22–25 at 4–5)

The Commission also requested comment regarding additional changes that should be considered in this area. In response, NFA urged the Commission to consider prohibiting exchange ''subscribers'' from accessing electronic exchanges where they have been barred by another exchange. (CL 22–22 at 5) As explained by NFA, the term ''subscriber'' describes the type of person that is equivalent to an FT. The Commission previously stated, when it adopted rules to govern FT registration, that it would defer consideration of the application of such requirements to persons using electronic trading systems to a later date.[38] To date, the Commission has not revisited the issue, and accordingly does not believe that it is appropriate to adopt NFA's request at this time. Nevertheless, the exchanges remain free to ban such ''subscribers''

agreements. *See also First American Discount Corp.* v. *CFTC,* 222 F.3d 1008 (D.C. Cir. Aug. 18, 2000).

[32] 65 FR at 39013.

[33] Rules 1.10(a)(2)(i)(C) and (a)(2)(ii)(C) have been further revised to make clear that the Form 1–FR–FCM or Form 1–FR–IB that must be submitted by new applicants for registration as FCMs and IBs with their application must be dated not more than 17 business days prior to the date on which such report is filed. This is consistent with Rules 1.10(a)(2)(i)(B) and (a)(2)(ii)(B).

[34] *See, e.g., In re Premex,* [1982–1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,992 (Feb. 1, 1984), *aff'd in relevant part, rev'd in part,* 785 F.2d 1403 (9th Cir. 1986).

[35] 65 FR at 39013.

[36] *Id.*

[37] In the Proposing Release, the Commission indicated that these letters would be published as an accompanying statement to this **Federal Register** release. The Commission has determined to add these letters to Appendix A to Part 3 because they relate to the issue of ''other good cause,'' which is discussed at the end of Appendix A, and to provide an easier way to access the texts of these letters.

[38] 58 FR 19575, 19576 (Apr. 15, 1993).

from access pursuant to their own rules and policies. As with the case of certified financial statements for FCM applicants discussed above, SROs may determine to impose requirements that are stricter than the minimum standards set forth in Commission rules.

D. Core Principal Three: Financial Requirements

1. Trading by Non-Institutional Customers on DTFs

Under the New Regulatory Framework, trading on DTFs would be limited to futures and options on specified commodities or those commodities deemed eligible under a case-by-case Commission determination.[39] In addition, DTFs could permit trading in any commodities if trading is limited to qualifying commercial participants.[40] The Commission proposed, however, that under certain conditions a DTF might permit non-institutional customers to enter into transactions thereon.[41] To address the higher degree of risk associated with the lower regulatory protections offered to DTF participants, such non-institutional customer business could be transacted only through a registered FCM that (1) Is a clearing member of at least one designated contract market or RFE, and (2) has a minimum adjusted net capital of at least $20 million.[42] Such an FCM is considered to be more capable of properly handling these transactions and the associated risk. The Commission further noted that, in order to provide guidance to such customers and their FCMs, NFA would issue a Statement of Acceptable Practices regarding additional disclosures to be made to non-institutional customers trading on DTFs and related issues involving price dissemination.[43]

Several commenters objected to the $20 million adjusted net capital requirement for FCMs set forth in Rule 1.17(a)(1)(ii) as proposed, stating that the amount was arbitrary, and urging that it be eliminated or reduced. (CL 22–35 at 8; CL 22–46 at 3–4; CL 22–48 at 3) The CBT observed that the $20 million minimum adjusted net capital requirement would prevent more than half of all registered FCMs from intermediating on DTFs for retail customers. (CL 22–25 at 5) Instead, the CBT suggested that the Commission focus on the FCM's record of customer protection, and permit any registered FCM to transact retail customer business on a DTF if the firm: (1) Has been registered as an FCM for at least three years; and (2) has not been found by a governmental or SRO authority to have committed any sales practice violations against retail customers during the past three years. (CL 22–25 at 5) Goldenberg, Hehmeyer & Co. (GHC) recommended that the Commission apply risk-based capital requirements in lieu of the $20 million minimum net capital requirement to assess the FCM's financial soundness. (CL 22–19 at 1–2) In a somewhat related vein, Treasury commented that a more appropriate measure of an intermediary's soundness is the amount of adjusted net capital in excess of the minimum required by regulation. (CL 22–34 at 3–4) Treasury further observed, however, that because the Commission's adjusted net capital requirements are based on the amount of segregated funds, whether excess adjusted net capital is an appropriate measure of an FCM's soundness in addition to total adjusted net capital depended on what the Commission ultimately decided on the segregation of funds issue. Accordingly, Treasury recommended that the Commission consider the segregation of funds issue in conjunction with its review of net capital rules. (CL 22–34 at 3–4)

Although MFA supported the Commission's proposal to allow non-institutional customers access to DTFs through qualifying FCMs (*i.e.,* those that are clearing members of at least one designated contract market or RFE and that have at least $20 million in adjusted net capital), it urged that customers who opted to trade through certain registered CTAs should also have such access. (CL 22–22 at 5) Specifically, MFA recommended that CTAs with at least $25 million in assets under management be permitted to access both exempt MTEFs and DTFs and engage in transactions on behalf of their customers in those markets. In support, MFA pointed out that in adopting Rule 30.12, which included in the definition of ''authorized customer'' any person whose investment decisions with respect to foreign futures and foreign option transactions are made by a CTA with total assets under management exceeding $50 million,[44] the Commission recognized that where a professional asset manager such as a CTA acts for a customer, it is appropriate to rely on the financial sophistication of the person managing the assets rather than on the sophistication of the individual CTA client. (CL 22–22 at 5) MFA further stated that because customers select their CTAs precisely on the basis of their determination that those CTAs are best qualified to make trading decisions on their behalf, precluding a CTA from being able to access DTF markets ''would * * * deprive customers of their ability to elect and receive the full benefits of the professional management for which the customer has retained the CTA.'' (CL 22–22 at 6) MFA estimated that less than 10 percent of all registered CTAs would qualify under a $25 million assets under management threshold, and expressed the view that this ''small but sophisticated'' class of CTAs would be an appropriate group for the Commission to permit access to all types of futures markets. (CL 22–22 at 8)

The Commission has reviewed these comments carefully. The Commission has determined to adopt, as proposed, the $20 million minimum adjusted net capital requirement for FCMs wishing to transact business on behalf of non-institutional customers on a DTF. The Core Principle addressing financial standards encourages intermediaries to maintain adequate capital to ensure they are able to meet their obligations to customers, and the Commission believes that the $20 million adjusted net capital requirement is a sufficient proxy for ensuring that FCMs will be financially capable of properly maintaining and servicing customer accounts. The Commission will monitor the effects of this requirement and make adjustments if appropriate.

The Commission has determined to add a new Rule 4.32 to permit registered CTAs to enter trades on or subject to the rules of a DTF on behalf of a non-institutional client, provided that the CTA: (1) Directs the client's commodity interest account;[45] (2) directs accounts containing total assets of not less than $25 million at the time the trade is entered; and (3) discloses to the client that it may enter trades on a DTF on the client's behalf. Paragraph (b) of Rule 4.32 further requires that the client's commodity interest account be carried by a registered FCM. An FCM who receives orders on behalf of a non-institutional customer from a CTA acting in accordance with Rule 4.32 need not maintain $20 million in minimum adjusted net capital, however. *See* Rule 1.17(a)(1)(ii)(B). In addition, a CTA placing trades on a DTF on behalf of a non-institutional client will be required to make any necessary

[39] 65 FR at 38990.

[40] *Id.*

[41] 65 FR at 39013.

[42] *Id.*

[43] *Id.*

[44] 65 FR at 47277.

[45] The term ''direct,'' as defined in Rule 4.10(f), refers to, in the context of trading commodity interest accounts, ''agreements whereby a person is authorized to cause transactions to be effected for a client's commodity interest account without the client's specific authorization.''

disclosures pursuant to Rule 4.34(h), which requires a CTA to disclose to the client if, pursuant to Rule 1.46, the CTA has instructed the FCM carrying the client account either not to close out all offsetting positions or to close out offsetting positions on other than a first-in, first-out basis. This issue is discussed in greater detail below.

2. Segregation of Funds

The Proposing Release raised two sets of questions seeking comments about whether, and under what circumstances, the Commission should permit (1) customers to opt out of segregation and (2) FCMs to maintain, in the same customer segregated account, various instruments, such as over-the-counter (OTC) derivatives, equity securities, and other cash market positions, as well as the funds used for the purpose of securing or margining such products and positions.[46] Differing views were presented on both issues, and the Commission has determined to defer action in these areas. With respect to customer opt-out of segregation, most parties commenting on the issue urged the Commission to consider thoroughly the potential implications with respect to the bankruptcy rules, *e.g.,* priority of distribution, before proceeding on the issue. (CL 22–18 at 1; CL 22–22 at 6; CL 22–25 at 7; CL 22–31 at 7–8; CL 22–32 at 14–15; CL 22–34 at 3) NFA further expressed the view that there was no current need for, or interest in, allowing institutional customers to opt out of segregation, as the FCM community is more interested in being able to provide customers with a unified account statement reflecting their holdings across all products, not just futures contracts. (CL 22–24 at 5)

In response to the Commission's query on whether the types of permissible instruments held in the same customer account should be expanded, FIA expressed the view that Section 4d(2) of the Act permits the Commission to authorize any FCM that wishes to carry a customer's cash, OTC derivatives, securities and futures positions in a single account to maintain that account as a customer segregated account. The CBT cautioned the Commission to give further consideration to bankruptcy implications before proceeding in this area. The Commission agrees that action on this issue should be deferred to allow for additional study and consultation with other regulators, including members of the President's Working Group (PWG), and in addition, that any ultimate determination must be made in conjunction with deciding the customer opt-out of segregation issue.[47]

3. Investment of Customer Funds

The Commission proposed to amend Rule 1.25, which sets forth the types of instruments in which FCMs and clearing organizations are permitted to invest customer funds pursuant to Section 4d(2) of the Act (permitted investments), by expanding the list of permitted investments.[48] Previously, an FCM or clearing organization was permitted to invest segregated funds only in obligations of the U.S., in general obligations of any State or of any political subdivision thereof, or in obligations fully guaranteed as to principal and interest by the U.S.

The Commission proposed, subject to specific risk-limiting features, to permit FCMs to invest customer segregated funds in the following additional instruments: (1) Obligations issued by any agency sponsored by the U.S.; (2) certificates of deposit issued by a bank, as defined in Section 3(a)(6) of the Securities Exchange Act of 1934, or a domestic branch of a foreign bank insured by the Federal Deposit Insurance Corporation; (3) commercial paper; (4) corporate notes; and (5) interests in money market mutual funds (MMMFs). In addition, an FCM or a clearing organization would also be permitted to both buy and sell the permitted investments pursuant to agreements for resale or repurchase of the instruments (repurchase transactions).[49]

The Proposing Release contained several provisions intended to minimize credit risk, market risk, and liquidity risk, including: (i) A requirement that the investments be highly-rated by a nationally-recognized statistical rating agency (NRSRO), except for U.S. government securities and those MMMFs that are not required to be rated; (ii) a requirement that the dollar-weighted average of the time remaining to maturity of the debt securities held in the segregated portfolio not exceed 24 months, excluding investment in MMMFs because MMMFs have no maturity date; (iii) concentration limits on the percentage of the portfolio that may be comprised of the securities of individual issuers; (iv) specific prohibitions against leverage, embedded derivatives, and options; and (v) a requirement that the daily value and gains and losses on each investment be included in the records of the FCM or clearing organization.[50]

In connection with the proposed revisions to Rule 1.25, the Commission also proposed to amend Rules 1.20(a) and 1.26(a) to eliminate the requirement that an FCM obtain a written acknowledgment, from each clearing organization where the FCM has deposited customer funds or instruments purchased with customer funds, that the clearing organization was informed that the customer funds or instruments purchased with customer funds and deposited therein belong to customers and are being held in accordance with the provisions of the Act and the rules and orders promulgated thereunder.[51] The elimination of the written acknowledgment requirement would be conditioned upon the clearing organization's adoption and submission to the Commission of rules that provide for the segregation as customer funds, in accordance with the Act and the Commission's rules and orders, of all funds held on behalf of customers and all instruments purchased with customer funds.[52]

In general, commenters responded favorably to the Commission's proposals to expand the permissible investments, and the Commission has determined to adopt the amendments generally as proposed.[53] Notwithstanding their overall support, however, commenters addressed several areas in which they sought additional adjustments or clarifications concerning the rule amendments. Commenters also responded to specific questions raised by the Commission in the Proposing Release.

The CBT suggested that the Commission set guidelines with regard to the marketability of the permitted investments. The CBT recommended that the guidelines limit permitted investments to those instruments for which there are available quotes or valuations and, further, that the guidelines provide that there be a likelihood that any permitted investments can be liquidated within a

[46] 65 FR at 39014.

[47] The Commission notes, however, that cross-margining arrangements are already in place with respect to trading of stock index options and stock index futures.

[48] 65 FR at 39014.

[49] *Id.*

[50] *Id.* at 39014–15.

[51] *Id.* at 39015.

[52] *Id.* This codifies a staff no-action letter issued three years ago. *See* CFTC Staff Letter No. 97–45, [1996–1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶27,085 (May 5, 1997).

[53] Because the Commission has determined to include MMMFs in the list of permissible investments for customer funds, subject to the limitations adopted in Rule 1.25, it is hereby rescinding Division of Trading and Markets Financial and Segregation Interpretation No. 9, which previously prohibited such investment. *See* Financial and Segregation Interpretation No. 9, 1 Comm. Fut. L. Rep. (CCH) ¶7,119 (Nov. 23, 1983).

reasonable time period. (CL 22–25 at 7) The final rule has been modified so that paragraph (b)(1) of Rule 1.25 requires that the permitted securities held in segregation be ''readily marketable'' consistent with SEC Rule 15c3–1 under the Securities Exchange Act of 1934.[54]

The CBT also recommended that the Commission use a simpler approach for the valuation of downgraded investments than the proposed 20 percent per day reduction. The CBT suggested instead that a set number of days be permitted for disposal of the investment and that, during that permitted time period, the firm be allowed to use the full market value of the instrument towards meeting its segregated liability. The CBT also indicated that it thought the 20 percent per day reduction in value for a downgraded instrument could lead to errors in calculation. (CL 22–25 at 7–8) The Commission has determined not to change this provision because it believes that the 20 percent per day write-down will provide an appropriate valuation under the circumstances and that it will serve as an incentive for the firm to take action to dispose of a downgraded investment sooner. *See* Rule 1.25(b)(2)(ii).

Rosenthal Collins Group, LLC (RCG) stated that the proposed credit rating requirements were too restrictive. (CL 22–18 at 2) The Commission notes that these requirements are intended to result in the holding of ''investment grade'' securities only. After the new rule takes effect, the Commission plans to monitor the effectiveness of the rule on an ongoing basis. If experience shows that the required ratings are too stringent, adjustments to the rule will be considered.

RCG also stated that the Commission should not impose rating requirements on investments in municipal securities because some of these securities are not rated due to the costs associated with obtaining a rating. RCG stated further that if the rule were adopted as proposed, investments that comply with the present rules but that do not comply with the new requirements should be ''grandfathered'' as part of an existing portfolio. (CL 22–18 at 2) In response to this comment, the Commission will not require the disposal of investments held as of December 13, 2000, *i.e.,* such investments may be held until they mature or are liquidated in the ordinary course of business, although no new acquisitions of non-compliant investments will be permitted.

Brown Brothers Harriman (BBH) stated that the prohibition against an FCM investing in an MMMF that has investments in securities issued by a parent or affiliate of the FCM should be dropped. (CL 22–20 at 5) This recommendation was made because MMMFs are often operated independently of the sponsoring affiliated entity and, in any event, are subject to a five percent concentration limit in the securities of any single issuer. BBH also noted that many FCMs are affiliated with world-class financial enterprises and that a prohibition against MMMFs investing in securities of the FCMs' affiliates would eliminate a large and important group of instruments. The Commission finds merit in this suggestion and has modified Rule 1.25(b)(6)(ii) accordingly. The Commission also notes that Section 17 of the Investment Company Act[55] restricts investments made by MMMFs in securities issued by any entity affiliated with the MMMF or its sponsors, and that the concentration limit set forth in SEC Rule 2a–7 under the Investment Company Act[56] is similar to the concentration provision of CFTC Rule 1.25.

BBH also requested that the requirement that a fund be ''SEC registered'' be defined to mean registration under the Investment Company Act only and not require registration under the Securities Act of 1933. (CL 22–20 at 6) This clarification has been made to paragraph (c)(1) of Rule 1.25.

Sentinel Management Group, Inc. (Sentinel) requested clarification as to whether the concentration limits provided for in the proposed rule would apply to securities held in connection with repurchase agreements. (CL 22–41 at 1) Sentinel stated that the concentration limits should not apply because of: (1) The burden that would be imposed upon the FCMs; (2) the fact that complete information on such securities is sometimes not known until the day following entry into the repurchase transaction; (3) the fact that the duration of repurchase transactions is only one day; and (4) the fact that the obligation created pursuant to a repurchase transaction is that of the counterparty and not the issuer of the securities. Therefore, it argued, the creditworthiness of the counterparty augments the value of the securities held pursuant to the repurchase agreement. (CL 22–41 at 1–2) This same point was raised by BBH in follow-up conversations.

Taking into consideration these comments, as well as the requirement contained in the Proposing Release that counterparties for repurchase transactions must be regulated financial institutions (generally large banks or brokerage firms), the Commission has concluded that the focus of concentration should be primarily upon the counterparties and secondarily upon the securities held in connection with the repurchase agreement. Therefore, the final rule contains several clarifying or enhancing changes.

First, paragraph (b)(4)(ii) provides that securities that are held by a counterparty, *i.e.,* securities that have been ''repoed out,'' are subject to the concentration limitations along with currently-owned direct investment securities. This clarification was made because a security that has been sold subject to repurchase at a later date presents the FCM or clearing organization with the same price risk as a security that is currently held in the portfolio. Second, paragraph (b)(4)(iii) provides concentration limit percentages for securities that are held by the FCM or clearing organization pursuant to a reverse repurchase agreement that are double those required for direct investments, provided that the counterparty has a credit rating of single A or higher from two or more NRSROs. In addition, the rule was changed to provide that the concentration percentages for such securities shall be computed using only the securities contained in the portfolio of securities supplied by each counterparty of the FCM or clearing organization. This change was made because the counterparty has the direct control over what specific securities will be supplied in a repurchase transaction. Thus, the Commission expects that an FCM or clearing organization will inform its counterparties as to the per-issuer concentration limits that must be observed, as set forth in the rule. Finally, paragraph (b)(4)(v) makes explicit that the concentration limits do not apply to securities owned by customers that have been posted by customers as collateral with the FCM. This clarification was made primarily because changes in the value of customer-owned securities accrue to the customers who posted the securities and, therefore, in a properly margined account such securities pose no direct price risk to the FCM. The Commission believes that these changes and clarifications will provide additional flexibility to FCMs and clearing

[54] 17 CFR 240.15c3–1. As a result of the addition of new Rule 1.25(b)(1), proposed paragraph (b)(6) of Rule 1.25 concerning recordkeeping is being adopted unchanged as paragraph (b)(7).

[55] 15 U.S.C. 80a–17.

[56] 17 CFR 270.2a–7.

organizations without unduly increasing associated risk.

The Investment Company Institute (ICI) suggested that MMMFs sponsored by investment advisers registered under the Investment Advisers Act of 1940 be included in the list of permitted investments. (CL 22–27 at 6) The Commission has made this suggested change. *See* Rule 1.25(c)(2).

ICI noted that the proposed rule appeared to require valuation of the investment portfolio by 9 a.m. each day and suggested, instead, that valuation not be required until after the close of the markets each day, *i.e.,* not until after 4 p.m. (CL 22–27 at 7) The Commission's intention was to require valuation by 9 a.m. the business day following the investment, so that the valuation would be available in time for the segregation calculation, which is required to be completed on a daily basis by noon the following business day. The final rule (paragraph (c)(4) of Rule 1.25) has been changed to correctly state the Commission's intention more precisely.

ICI also suggested that the proposed rule should be changed to permit MMMFs that are not rated by an NRSRO to invest in unrated securities. The proposed rule provided that only MMMFs that are rated may invest in unrated securities. ICI cited the comprehensive approach to risk control and preservation of capital contained in SEC Rule 2a–7 and noted that that rule permits an MMMF to invest in unrated securities if the MMMF determines that the securities are of comparable quality to otherwise eligible securities. (CL 22–27 at 4) The Commission has changed the final rule (Rule 1.25(b)(2)(i)(D)) to permit unrated MMMFs to invest in unrated securities because of the risk-limiting features of SEC Rule 2a–7.

ICI also recommended two revisions to paragraph (c)(3) of Rule 1.25 concerning MMMFs. First, because fund shares are usually uncertificated, ICI recommended that the first sentence be revised to provide that the ownership of fund shares must be noted (by book-entry or otherwise) in a custody account of the FCM or clearing organization. Second, to ensure that confirmations for transactions in fund shares are retained, ICI recommended that the confirmation relating to the purchase be retained in the FCM's or clearing organization's records. (CL 22–27 at 6) The Commission has made these suggested changes.

ICI further recommended that the one-day liquidity requirement applicable to MMMFs be extended to seven days, to be consistent with SEC requirements and the longer settlement time-frames associated with direct investments. (CL 22–27 at 7)

The Commission believes the one-day liquidity requirement for investments in MMMFs is necessary to ensure that the funding requirements of FCMs will not be impeded by a long liquidity time frame. Since a material portion of an FCM's customer funds could well be invested in a single MMMF, this is an important provision of the rule. The Commission notes that, although sales of directly-owned securities settle in longer than one-day time-frames, an FCM or clearing organization could obtain liquidity by entering into a repurchase transaction. Therefore, the Commission has retained the one-day liquidity requirement imposed on investments in MMMFs and, in view of the importance of this provision, has clarified that demonstration that this requirement has been met may include either an appropriate provision in the offering memorandum of the fund or a separate side agreement between the fund and an FCM or clearing organization. *See* Rule 1.25(c)(5).

The FRBC commented that permitted investments should have either a CUSIP or ISIN number, and that permitted investments should be required to have a reasonably transparent secondary market enabling accurate and efficient valuation of the investments. (CL 22–30 at 6) The Commission has changed the final rule to include securities with ISIN numbers as permitted investments.

The FRBC also recommended that permitted investments have a reasonably transparent secondary market. As noted above, the Commission strengthened the rule in this respect by adding a requirement that all permitted securities, except for MMMFs, meet the SEC's ''readily marketable'' standard. The Commission intends to monitor closely for any problems concerning valuation of permitted investments, and will consider proposing further rule amendments if appropriate.

The FRBC also recommended that permitted investments should settle on a same-day or next-day basis, to ensure adequate liquidity. It pointed out that, currently in the U.S., virtually all corporate and municipal debt securities settle on a T+3 basis, which is not sufficient for futures clearing organization demands, and that this delay could deprive the FCM or clearing organization of the liquidity that is so important in times of market stress or emergency. (CL 22–30 at 5) The Commission has elected to permit investment of customer funds in investment grade corporate notes and municipal securities because FCMs have methods of obtaining liquidity other than by selling the securities, such as by entering into repurchase transactions and by establishing backup bank lines of credit using the securities as collateral.

The FRBC further recommended that CFTC rules should permit the investment of customer funds held in a foreign currency in identically-denominated sovereign debt securities. (CL 22–30 at 4–5; *see also* CL 22–31 at 9; CL 22–42 at 2) The Commission notes that, under the rule as proposed, an FCM that decided to invest deposits of foreign currencies was required to convert the foreign currencies received to a U.S. dollar-denominated asset. This would increase its exposure to foreign currency fluctuation risk, unless it incurred the additional expense of hedging. Therefore, the Commission has determined that the FRBC's suggestion should be adopted. The Commission has changed the proposed rule to permit investment in the general obligations of any country whose sovereign debt is rated in the highest category by at least one NRSRO, but limited as follows: an FCM may invest in the sovereign debt of a country to the extent it has balances owed to its customers denominated in that currency; a clearing organization may invest in the sovereign debt of a country to the extent it has balances owed to its clearing member FCMs denominated in that currency.[57] The Commission notes that foreign sovereign debt that is denominated in the Euro will qualify as a permitted investment under this rule, provided the country that issued the debt qualifies as a permitted country under the rule, the obligation is a general obligation of the country, and the balances owed to the customers or the FCMs are Euro-denominated. As with other aspects of Rule 1.25, the Commission will monitor the effect of this provision and stands ready to make additional adjustments as experience dictates.

In addition, the FRBC suggested that the CFTC expressly approve the use of certain ''sweep'' accounts in connection with the investment of customer funds in MMMFs or other permissible forms of investment. (CL 22–30 at 6) The Commission notes that Rule 1.25 will not preclude the use of sweep accounts and encourages this practice to enhance the efficiency of liquidity management.

The FRBC also suggested that, with respect to the concentration provision, the rule should be clarified that it applies only to the portfolio of securities

[57] As is the case for U.S. government securities and those MMMFs that are not required to be rated, permitted foreign sovereign debt will not be subject to a credit rating requirement. *See* § 1.25(b)(2)(i)(A).

purchased with customer funds, *i.e.,* the provision does not apply to customer-owned securities posted as margin. (CL 22–30 at 6) As noted previously, the Commission has made this clarification in paragraph (b)(4)(v) of Rule 1.25.

FIA suggested that the Commission clarify what is meant by the required ratings in the rule, where the ''two highest ratings of an NRSRO'' are specified, *i.e.,* AAA and AA. In particular, it recommended that the Commission clarify whether ''AA'' includes all variations included within the AA rating. (CL 22–31 at 8) The Commission confirms that this interpretation is correct.

FIA also suggested that the Commission clarify whether a security would be a permitted investment if one NRSRO gave it an acceptable rating, even though another NRSRO gave it an unacceptable rating. (CL 22–31 at 9) The Commission hereby confirms that if one NRSRO gave an acceptable rating and another did not, investment in the security would be permitted. The Commission believes that it would be rare for such differences to occur at the investment grade ratings level and, further, that any differences would probably be temporary.

FIA also suggested providing a grace period for FCMs or clearing organizations that find themselves in violation of the concentration limits. (CL 22–31 at 9) The Commission has decided against adopting this suggestion because the Commission would not expect FCMs to violate the concentration limits, except perhaps under unusual circumstances. Further, the Commission is concerned that were a formal grace period provided in the rule, it might be subject to abuse.

In addition, FIA suggested that the Commission plan to review the list of permitted investments every six months to determine whether revisions should be made. (CL 22–31 at 9) The Commission plans to review all aspects of the new rule on an ongoing basis and further changes will be proposed, if appropriate.

Two exchanges, the NYMEX and the CME, pointed out that each clearing organization would need to make its own determination as to the types of assets that would be accepted by that clearing organization. (CL 22–32 at 16; CL 22–35 at 13) The Commission recognizes that an SRO may adopt more restrictive requirements than those set forth in Rule 1.25 for its member FCMs.

E. Core Principle Four: Risk Disclosure and Account Statements

Although the Commission stated in the Proposing Release that non-institutional customers should continue to receive the risk disclosures regarding futures and options trading that are currently required,[58] it proposed to streamline the account opening process by amending Rules 1.55(d)(1) and (2) to expand the list of disclosures and consents that could be provided in a single document and acknowledged with a single signature.[59] This list includes: (1) The disclosures required by new Rule 1.33(g) (relating to electronic transmission of statements);[60] (2) the consent referenced in Rule 155.3(b)(2) (relating to customer permission for FCMs to take the opposite side of an order); and (3) a provision for preauthorization of transfers of funds from a customer's segregated account to another account of that customer. The single signature could be made electronically as provided for in recently-adopted Commission Rules 1.3(tt) and 1.4.[61] Disclosure concerning arbitration of disputes, however, would continue to require a separate signed acknowledgement by non-institutional customers, pursuant to proposed Rule 166.5 (which was modeled on, and would replace, prior Rule 180.3).[62]

All of the commenters who addressed the proposed amendments to Rule 1.55(d) responded favorably to the expansion of disclosures and consents that could be acknowledged and made by a single signature, and the Commission is adopting the amendments as proposed. (CL 22–17 at 3; CL 22–24 at 6; CL 22–25 at 8; CL 22–31 at 14; CL 22–32 at 16; CL 22–35 at 11; CL 22–44 at 2) FIA requested that the Commission confirm that an FCM may obtain an acknowledgement of receipt and understanding of the risk disclosure statement contemporaneously with opening an account. The Commission agrees that the FCM may open the customer account simultaneously with receiving the acknowledgment of receipt and understanding of the risk disclosure statement, along with margin funds and any other required account opening documents, from the customer. The FCM will remain responsible for ensuring that the risk disclosure document is furnished to the customer in such a way that the customer can review and understand the document before committing funds to the FCM.

NFA commented generally that the Commission should not dictate the specifics of how disclosures and consents are delivered and acknowledged, and that it would be willing to develop best practice guidance in this area. (CL 22–24 at 6) The Commission believes that its rules requiring risk disclosure and customer acknowledgments do not impose a significant burden in light of their important customer protections. The Commission is providing additional flexibility to the industry in this area. As the Commission noted in the Proposing Release, there would continue to be no specific disclosure requirements for institutional customers and, in addition, as provided in Rule 35.1(b), governmental entities would be included in the definition of ''institutional customer,'' and consequently would not be required to receive and to acknowledge a disclosure statement.[63] Further, the single signature acknowledgment could be made electronically as provided for in Rules 1.3(tt) and 1.4. The Commission looks forward to working with NFA and the industry both in developing a Statement of Acceptable Practices for disclosure to non-institutional customers trading on DTFs, and in developing more streamlined disclosure requirements for domestic exchange-traded options under Rule 33.7.

As noted above, the Commission proposed to continue to require a separate signed acknowledgement by non-institutional customers with respect to disclosure concerning arbitration of disputes. Nevertheless, the Commission also solicited comment on whether to maintain this requirement.[64] FIA opposed continuing to require a separate signature from non-institutional customers if their account agreement contains a pre-dispute arbitration provision. (CL 22–31 at 14) In general, FIA expressed the opinion that the Commission should eliminate all of its rules pertaining to the use of pre-dispute arbitration agreements, as well as the Commission's reparations program. For example, FIA commented that the Commission's rule that an FCM may not require a customer to sign a pre-dispute arbitration agreement as a condition to opening an account with the FCM inhibits the ability of FCMs that are also securities broker-dealers to enter into a single agreement with their customers, because the SEC does not prohibit the use of such mandatory agreements. (CL 22–31 at 10) At the very least, FIA stated that the Commission

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[58] 65 FR at 39015. There would continue to be no specific disclosure requirements for institutional customers. Id. at 39016.

[59] *Id.* at 39015–16.

[60] *See infra.*

[61] 65 FR 12466 (Mar. 9, 2000).

[62] 65 FR at 39016. This is discussed further below.

[63] *Id.*

[64] *Id.*

should permit institutional customers contractually to waive their right to file a complaint under the Commission's reparations program. (CL 22–31 at 10) In this regard, NFA maintained that intermediaries and institutional customers should be allowed to negotiate *all* terms in pre-dispute arbitration agreements. (CL 22–24 at 8).

The Commission is adopting Rule 166.5 as it pertains to non-institutional customers as proposed. Further, the Commission believes that no customer, regardless of their level of sophistication, should be required to sign a pre-dispute arbitration agreement as a condition for doing business in the futures industry. The Commission has determined, however, to allow institutional customers and intermediaries to negotiate any terms of a pre-dispute arbitration agreement as they deem appropriate, including a waiver of the customer's right to file a complaint under the Commission's reparations program. Accordingly, the definition of the term ''customer'' in Rule 166.5(a)(2) has been changed to exclude institutional customers from general application of the rule. In addition, new paragraph (g) has been added to make clear that an institutional customer and a registrant may negotiate any terms of a pre-dispute arbitration agreement, except that the institutional customer may not be required to sign a pre-dispute arbitration agreement as a condition of opening an account with the registrant.[65]

NFA specifically requested that the Commission clarify the reach of pre-dispute arbitration agreements and confirm that such agreements are binding on both the intermediary as well as the customer, unless the agreement states specifically that the registrant is not required to arbitrate its claims.[66] (CL 22–24 at 9) Former Part 180, which is to be replaced by Rule 166.5, was mainly intended to provide for fair and equitable SRO arbitration forums and to prevent firms from requiring customers to agree to arbitration in order to do business. Part 180 did not require registrants to submit their claims against customers to arbitration, and the Commission did not propose to require that registrants do so in the Proposing Release. Thus, provided that a registrant pursues a dispute in accordance with the terms of the customer agreement, and the procedures followed do not violate Rule 166.5, Commission rules would not prohibit the registrant's actions.

NFA also objected to proposed Rule 166.5(f), which would permit counterclaims that do not arise out of the same transaction or occurrence that is the subject of the original claim only if (1) The customer agreed to the counterclaim being heard after it has arisen, and (2) the aggregate monetary value of the counterclaim is capable of calculation. NFA believes that, for both retail and institutional customers, the parties should be allowed to agree in advance that any counterclaim would be required to be included in the arbitration proceeding. (CL 22–24 at 9) The Commission has determined to adopt NFA's suggestion, and has revised Rule 166.5(f) to permit any counterclaim arising out of a transaction subject to the Act and Commission regulations promulgated thereunder for which a non-institutional customer has utilized the services of a registrant, to be made part of an arbitration proceeding between the non-institutional customer and the registrant where the parties have agreed in advance to require that any such claim be included in the arbitration proceeding, provided that the aggregate monetary value of the counterclaim is capable of calculation. As noted above, under Rule 166.5(g), institutional customers remain free to negotiate any terms of their pre-dispute arbitration agreement, including the type of counterclaims that may be included in an arbitration proceeding.

F. Core Principle Five: Trading Standards

The Commission proposed that Rules 155.1, 155.3 and 155.4, which collectively require FCMs and IBs to establish and to maintain supervisory procedures to assure that neither they nor any affiliated persons use their knowledge of customer orders to the customer's disadvantage, would continue to apply to intermediation of trades on contract markets. These requirements would be extended to trading on RFEs, and to trading by non-institutional customers on DTFs under new Rule 155.6(a).[67] These rules over the years have helped the Commission deter such practices as ''front-running,'' ''trading ahead,'' ''bucketing,'' taking the opposite side of customer orders, and improper disclosure of customer orders. However, for intermediation of trades by institutional customers at DTFs, the Commission proposed a new Rule 155.6(b), which set forth a general standard of practice in this area that parallels the language of the core principle concerning trading standards. The Commission stated that ''it is nevertheless intended to proscribe the same trade practice abuses as Rules 155.1–155.5.''[68]

The commenters who addressed this section were critical of the Commission's approach. The CBT expressed its belief that all prescriptive rules regarding trading practices should be replaced with core principles, not just the rules governing trades for institutional customers on DTFs. (CL 22–25 at 8) MFA stated that it was inconsistent to add a general prohibition against ''misuse'' of knowledge as contained in Proposed Rule 155.6(b) if the rule was intended to proscribe the same trade practice abuses referred to in Rules 155.1–155.5. (CL 22–22 at 13–14) NFA commented that RFEs and DTFs should not be treated differently with respect to trading standards rules, because otherwise operators of DTFs would have a competitive advantage over operators of RFEs. (CL 22–24 at 6)

The Commission has determined to leave unchanged Rules 155.1–155.5 at this time, and to adopt Rule 155.6 as proposed. The Commission believes that the existing rules should continue to apply in connection with non-institutional customer trades no matter where they occur because of such customers' greater susceptibility to trading abuses by intermediaries, as compared to institutional customers. The Commission recognizes that, with respect to institutional customers trading on a DTF, a general standard of practice is more appropriate. However, the Commission remains open to specific suggestions regarding how individual provisions in Rules 155.3 and 155.4 might be streamlined.

The Commission notes that because the core principle concerning trading standards states that intermediaries must not misuse their knowledge of their customers' orders without making any distinctions regarding the nature of the customer, the same trade practice abuses that are proscribed by Rules 155.1–155.5 should also be considered

[65] As a result of these changes, proposed paragraphs (c)(2) (ii) and (iii) of Rule 166.5 are adopted as paragraphs (c)(2) (i) and (ii), respectively. In addition, to reflect the recent amendments to Rule 4.7, paragraph (c)(2)(ii) of Rule 166.5 (formerly paragraph (c)(2)(iii)) has been modified to apply to a person who is a ''qualified eligible person'' as defined by Rule 4.7. *See* 65 FR 47848 (Aug. 4, 2000).

[66] NFA referred to several recent lower court cases where registrants who brought debit balance claims against their customers in state court successfully argued, in response to the customers' attempts to force the claims to arbitration, that a pre-dispute arbitration agreement did not apply to their claims against customers. NFA questioned the logic of these decisions, stating that there is no consideration for a customer to sign a pre-dispute arbitration agreement if it does not apply to the intermediary's claims as well. (CL 22–24 at 9)

[67] 65 FR at 39016.

[68] *Id.*

as being in violation of Rule 155.6(b). The Commission believes that its overall approach with respect to trading standards strikes a reasonable balance in preserving rules that have worked successfully over the years in curbing abusive trading practices, while relaxing certain of the specific provisions of the existing rules in connection with the trading on DTFs by more sophisticated customers.

G. Core Principle Seven: Reporting Requirements

The Commission proposed to apply its existing large trader reporting requirements to intermediaries on RFEs, but would reduce reporting requirements with respect to intermediaries transacting business on DTFs, because of the nature of the instruments traded or the limited access granted to non-institutional traders. Intermediaries trading on DTFs would be subject to large trader reporting requirements only by special call.

The Commission received varying comments in response to its large trader reporting proposal. NFA agreed with both aspects of the Commission's proposal, asserting that large trader reporting requirements should remain in place for intermediaries on RFEs, while a more flexible approach would be appropriate for gathering information from intermediaries trading on DTFs. (CL 22–24 at 7) FC Stone suggested that reduced large trader reporting should be available to all FCMs with institutional customers only, not just to those trading on DTFs. (CL 22–44 at 4) The CBT stated that the Commission should permit individual markets to require large trader reporting, as they deem necessary, and that any large trader reporting to the Commission should be done pursuant to special call, without drawing a distinction between DTFs and RFEs. (CL 22–25 at 8–9) NIBA also commented that the Commission should not make a distinction between DTFs and RFEs; NIBA stated, however, that regular large trader reports should be required on both types of exchanges, and that otherwise customers who trade on RFEs would lose the benefit of price transparency. (CL 22–17 at 4) Treasury expressed concern about the mechanics of large trader reporting on a DTF, stating that because eligible participants would not be required to use FCMs to execute trades on a DTF, it was unclear how large trader positions could be reported. In addition, Treasury noted that large trader reporting requirements have worked well in the market for Treasury bond futures, both for the information they reveal to regulators and their deterrent effect, and consequently, urged the Commission to establish a mechanism for large trader reporting for government securities futures trading on DTFs. (CL 22–34 at 4) The Economic Strategy Institute agreed with Treasury that the elimination of large trader reports would reduce the Commission's ability to effectively detect and deter manipulation. (CL 22–45 at 2) Finally, the American Farm Bureau Federation, the American Soybean Association, the National Association of Wheat Growers, the National Cattlemen's Beef Association, the National Corn Growers Association, the National Farmers Union, the National Grain Sorghum Producers and the National Pork Producers Council collectively commented that if the Commission determined to permit agricultural products to be traded on a DTF, large trader reports relating thereto should be filed with the Commission. (CL 22–51 at 1)

The Commission has determined to adopt the large trader reporting requirements for RFEs and DTFs as proposed, except that large trader reports will not be required from participants trading on a commercial-participant DTF. The reporting system is critical to the Commission's ability to oversee markets and provides a valuable bulwark against illegitimate trade practices. RFEs in particular permit unconditioned access to any type of trader, including both institutional and non-institutional customers or participants, and may list contracts on any type of commodity, including those based on commodities that have finite deliverable supplies or cash markets with limited liquidity. Such markets potentially have a greater susceptibility to price manipulation and raise greater customer protection concerns than do DTFs. Consequently, regular large trader reports are necessary to enable the Commission to carry out its oversight responsibilities for RFE markets.

With respect to intermediaries transacting business on DTFs, however, because of the nature of the instruments traded and the limited access granted to non-institutional traders, large trader reporting on a less routine basis, *i.e.*, upon special call by the Commission, is more appropriate. Where trading access on a DTF is restricted to eligible commercial participants only, however, large trader reports generally will not be required from such participants.[69] The Commission will rely instead on its investigative authority, which also applies to a person's cash market activities.[70]

H. Core Principle Eight: Recordkeeping

1. General

The Core Principles state that all registrants must keep full books and records of their activities related to their business. Thus, the Commission did not propose to amend any of its recordkeeping requirements in the Proposing Release.[71] NFA asked the Commission to consider replacing Rule 1.31 with a core principle and acceptable practice guidance that follows NFA's December 1997 proposal. NFA's proposal recommended that Rule 1.31 be rewritten to require only that registrant recordkeeping systems meet general reliability and accessibility standards. (CL 22–24 at 7) The Commission revised Rule 1.31 in 1999 to provide additional flexibility to recordkeepers, allowing them to store most required records on either micrographic or electronic storage media for the full five-year required retention period.[72] The Commission intends to revisit NFA's proposal in the future and, where appropriate, will undertake to work with the SEC to make additional changes in this area.

2. Customer Account Statements; Close-Out of Offsetting Positions

The Commission proposed to codify its June 1997 advisory relating to the electronic transmission of account statements in a new Rule 1.33(g).[73] Thus, an FCM would be permitted, with customer consent, to deliver required confirmation, purchase-and-sale, and monthly account statements electronically in lieu of mailing a paper copy. FCMs would need only to retain the daily confirmation statement as of the end of the trading session, provided that it reflects all trades made during that session. Before transmitting any statement electronically to a customer, however, the FCM would be required to make certain disclosures regarding the practice, and in the case of non-institutional customers, the FCM would be required to obtain the customer's signed consent acknowledging the disclosures. The acknowledgement could be made through a single signature in accordance with Rule 1.55 as discussed above. NIBA and FC Stone responded favorably to the

[69] As explained in a companion release in today's edition of the **Federal Register**, large trader reports may be required upon special call depending upon the nature of the commodity interest traded on a commercial-participant DTF.

[70] Large trader reports may be required upon special call on the DTF itself, however. *See* § 37.6(a).

[71] 65 FR at 39017.

[72] 64 FR 28735.

[73] 65 FR at 39017; *see also* 62 FR 31507 (June 10, 1997).

Commission's proposal (CL 22–17 at 3; CL 22–44 at 2), while NFA commented that the 1997 Advisory should be treated as acceptable practices guidance rather than codified in a new rule. (CL 22–24 at 7) The Commission has determined to adopt the rule as proposed, believing that, as noted previously, a certain level of uniformity and standardization is essential in an area such as reporting to customers to facilitate the processing of massive quantities of data, which is often accomplished by third-party, ''back office'' firms.

The Commission also proposed to revise Rule 1.46 to allow customers or account controllers to instruct the FCM if they wished to deviate from the default rule that the FCM close out offsetting positions on a first-in, first-out basis, looking across all accounts it carries for the same customer.[74] CPOs and CTAs would be required to disclose, under proposed amendments to Rules 4.24(h)(2) and 4.34(h), respectively, if they instruct an FCM to deviate from the default rule for closing out offsetting positions.[75]

After considering the comments received, the Commission is adopting the revisions as proposed. Nevertheless, the Commission agrees with NFA that FCMs should closely monitor the activity in those customer accounts that depart from the default close-out method set forth in Rule 1.46 to ensure that their customers are not offsetting their positions other than by a first-in, first-out method solely to avoid taxes, to launder money, or to improve their delivery position. (CL 22–24 at 7)

In addition, the Commission believes that customers may transmit their offset instructions to their FCMs orally, as requested by FIA. (CL 22–31 at 8) In the case of CPOs and CTAs, the Commission agrees with MFA that responsibility for transmitting instructions regarding offset should normally lie with the registrant directing trading. Generally, where a pool's trading is directed by a CTA, this should be the CTA, not the CPO. (CL 22–22 at 14) The Commission does not agree, however, that it is unnecessary to require CPOs and CTAs to disclose whether they instructed their FCM to offset positions in a manner other than by a first-in, first-out method. The Commission does not believe that this requirement would impose a significant burden on CPOs and CTAs, particularly in light of the fact that these entities would no longer be prevented from offsetting their positions in a manner other than on a first-in, first-out basis, as was previously the case. The Commission believes that it is appropriate in this area to provide greater choice balanced with disclosure as to the method of operation.

III. Section 4(c) Findings

Certain of these final rules and rule amendments are being promulgated under Section 4(c) of the Act, which grants the Commission broad exemptive authority. Section 4(c) of the Act provides that, in order to promote responsible economic or financial innovation and fair competition, the Commission may, by rule, regulation or order, exempt any class of agreements, contracts or transactions, including any person or class of persons offering, entering into, rendering advice or rendering other services with respect to, the agreement, contract, or transaction, from the contract market designation requirement of Section 4(a) of the Act, or any other provision of the Act other than Section 2(a)(1)(B), if the Commission determines that the exemption would be consistent with the public interest. Furthermore, Section 4(c)(2) of the Act provides that the Commission may not grant an exemption from the contract market designation requirement of Section 4(a) of the Act unless the Commission also finds that: (i) The contract market designation requirement should not be applied to the agreement, contract, or transaction for which the exemption is requested and the exemption would be consistent with the public interest and the purposes of the Act; (ii) the exempted transaction will be entered into solely between ''appropriate persons''; and (iii) the agreement, contract or transaction in question will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act. For the reasons stated below, the Commission believes that issuing the exemptive relief as set forth in these final rules and rule amendments is consistent with those determinations.

As explained above, certain of the final rules and rule amendments would provide greater flexibility for intermediaries and their customers in several areas. Specifically, the Commission is adopting final rule amendments concerning the definition of the term ''principal'' that recognize the evolution of management structures by reducing the number of officers that will be considered principals, while ensuring that appropriate personnel that perform significant roles within the firm remain listed as such. In addition, the Commission is expanding the range of instruments in which FCMs may invest customer funds beyond those listed in Section 4d(2) of the Act to enhance the yield available to FCMs, clearing organizations and their customers, without compromising the safety of customer funds. These final rule amendments acknowledge the development of new financial instruments over the last 60 years, and should both enable FCMs to remain competitive globally and domestically and maintain safeguards against systemic risk. In light of the foregoing, the Commission has determined that the adoption of the final rules and rule amendments relating to the definition of the term ''principal'' and the expansion of permitted instruments for the investment of customer funds will be consistent with the public interest.

Further, the final rules and rule amendments adopted herein, as well as the existing rules as they also relate to the transaction of business by intermediaries, will be applied, or extended, to agreements, contracts and transactions carried out on new markets, *i.e.,* RFEs and DTFs. As more fully discussed in a companion release published in this edition of the **Federal Register**, the rules pertaining to the new markets establish a new regulatory framework that is intended to promote innovation and competition in the trading of derivatives and to permit the markets the flexibility to respond to technological and structural changes in the markets. The new framework establishes three regulatory tiers with regulations tailored to the nature of the commodities traded and the nature of the market participant, and access to each of the tiers is dependent upon the appropriateness of the participant. In this respect, the Commission believes that the actions taken herein are consistent with the ''public interest'' as that term is used in Section 4(c) of the Act. When that provision was enacted, the Conference Report accompanying the Futures Trading Practices Act of 1992[76] stated that the ''public interest'' in this context would ''include the national public interests noted in the Act, the prevention of fraud and the preservation of the financial integrity of the markets, as well as the promotion of responsible economic or financial innovation and fair competition.''[77]

[74] 65 FR at 39017.

[75] *Id.*

[76] Pub. L. No. 102–546 (1992), 106 Stat. 3590.

[77] H.R. Rep. No. 978, 102d Cong., 2d Sess. 78 (1992). The Conference Report also states that the reference in Section 4(c) to the ''purposes of the Act'' is intended to ''underscore [the Conferees'] expectation that the Commission will assess the

Continued

The Commission has retained or adopted safeguards to ensure that transactions will be carried out between appropriate persons. Appropriate persons can include, beyond those specified in Section 4(c)(3)(A)–(J) of the Act, ''[s]uch other persons that the Commission determines to be appropriate in light of their financial or other qualifications, or the applicability of appropriate regulatory protections.'' [78] The Commission has determined that it is appropriate to permit any person to trade on an RFE because the rules pertaining to RFEs will be closest to those currently pertaining to contract markets and the bulk of the existing regulatory framework pertaining to intermediaries will apply in connection with their intermediation of transactions on RFEs. On the other hand, customers on DTFs, which will be subject to looser regulation than RFEs, are generally restricted to the types of persons specified in Section 4(c)(3)(A)–(J) of the Act. The Commission has determined, however, that it is appropriate to allow access to retail, or non-institutional, customers on DTFs, subject to stated limits and conditions. For example, if a non-institutional customer seeks to enter into transactions on a DTF permitting such access, such customer may only do so through either: a) a registered FCM that is a clearing member of at least one designated contract market or RFE, and that has adjusted net capital of at least $20 million; or b) a registered CTA who has discretionary authority over the non-institutional customer's account, and who has assets under management of not less than $25 million. The Commission further believes that, in light of these conditions and safeguards, the exemptive relief would have no adverse effect on any of the regulatory or self-regulatory responsibilities imposed by the Act.

IV. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA), 5 U.S.C. 601 *et seq.* (1994 & Supp. II 1996), requires federal agencies, in proposing rules, to consider the impact of those rules on small businesses. The rules adopted herein would affect FCMs, IBs, CPOs, CTAs, FBs, FTs, leverage transaction merchants (LTMs) and agricultural trade option merchants (ATOMs), as well as principals thereof. 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.[79] The Commission has previously determined that registered FCMs, CPOs, LTMs and ATOMs are not small entities for the purpose of the RFA.[80] With respect to IBs, CTAs, FBs and FTs, the Commission has stated that it is appropriate to evaluate within the context of a particular rule proposal whether some or all of the affected entities should be considered small entities and, if so, to analyze the economic impact on them of any rule. In this regard, the rules being adopted herein would not require any registrant to change its current method of doing business. For many registrants, the revisions should decrease the number of persons within the registrant's organization who would be considered principals under the CFTC rules. Further, the revisions should reduce, rather than increase, the regulatory requirements that apply to registrants and applicants for registration, regardless of size. Accordingly, pursuant to 5 U.S.C. 605(b), the Chairman, on behalf of the Commission, certifies that the action taken herein will not have a significant economic impact on a substantial number of small entities. In this regard, the Commission notes that it did not receive any comments concerning the RFA implications of the rules and rule amendments discussed herein.

B. Paperwork Reduction Act

As required by the Paperwork Reduction Act of 1995 [44 U.S.C. 3507(d)], the Commission submitted a copy of the proposed amendments to its rules to the Office of Management and Budget for its review. The Commission did not receive any comments on any potential paperwork burden associated with the Proposing Release.

List of Subjects

17 CFR Part 1

Brokers, Commodity futures, Consumer protection, Reporting and recordkeeping requirements.

17 CFR Part 3

Administrative practice and procedure, Brokers, Commodity futures, Principals, Registration, Reporting and recordkeeping requirements.

17 CFR Part 4

Advertising, Commodity futures, Commodity pool operators, Commodity trading advisors, Consumer protection, Disclosure, Principals, Reporting and recordkeeping requirements.

17 CFR Part 140

Authority delegations (Government agencies), Conflict of interests, Organization and functions (Government agencies).

17 CFR Part 155

Brokers, Commodity futures, Reporting and recordkeeping requirements.

17 CFR Part 166

Brokers, Commodity futures, Consumer protection, Reporting and recordkeeping requirements.

In consideration of the foregoing, and pursuant to the authority contained in the Commodity Exchange Act, and in particular, Sections 2, 4(c), 4b, 4d, 4f, 4m, 4n, 8a, and 19 thereof, 7 U.S.C. 2, 6(c), 6b, 6d, 6f, 6m, 6n, 12a and 23, the Commission hereby amends Parts 1, 3, 4, 140, 155 and 166 of 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. 1a, 2, 2a, 4, 4a, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 7, 7a, 7b, 8, 9, 12, 12a, 12c, 13a, 13a–1, 16, 16a, 19, 21, 23 and 24.

2. Section 1.3 is amended by adding new paragraphs (g), (m) and (v) to read as follows:

§ 1.3 Definitions.

* * * * *

(g) *Institutional customer.* This term has the same meaning as ''eligible participant'' as defined in § 35.1(b) of this chapter.

* * * * *

(m) *Derivatives transaction facility.* This term has the same meaning as a ''derivatives transaction facility'' under part 37 of this chapter.

* * * * *

(v) *Recognized futures exchange.* This term has the same meaning as a ''recognized futures exchange'' under part 38 of this chapter.

* * * * *

3. Section 1.10 is amended as follows:

a. Revising paragraph (a)(2)(i)(B);

b. Adding paragraph (a)(2)(i)(C);

c. Designating the undesignated paragraph following paragraph

impact of a proposed exemption on the maintenance of the integrity and soundness of markets and market participants.'' *Id.*

[78] See Section 4(c)(3)(K) of the Act, 7 U.S.C. 6(c)(3)(K).

[79] 47 FR 18618–21 (Apr. 30, 1982).

[80] *Id.* at 18619–20 (discussing FCMs and CPOs); 54 FR 19556, 19557 (May 8, 1989) (discussing LTMs); and 63 FR 18821, 18830 (Apr. 16, 1998) (discussing ATOMs).

(a)(2)(i)(B) as paragraph (a)(2)(i)(D) and revising it;

d. Designating the undesignated paragraph following paragraph (a)(2)(ii)(C) as paragraph (a)(2)(ii)(E) and revising it;

e. Redesignating paragraph (a)(2)(ii)(C) as (a)(2)(ii)(D) and revising it; and

f. Adding a new paragraph (a)(2)(ii)(C).

The revisions and additions read as follows:

§ 1.10 Financial reports of futures commission merchants and introducing brokers.

(a) * * *

(2) * * *

(i) * * *

(B) A Form 1–FR–FCM as of a date not more than 17 business days prior to the date on which such report is filed and a Form 1–FR–FCM certified by an independent public accountant in accordance with § 1.16 as of a date not more than one year prior to the date on which such report is filed; or

(C) A Form 1–FR–FCM as of a date not more than 17 business days prior to the date on which such report is filed, *Provided, however,* that such applicant shall be subject to a review by the applicant's designated self-regulatory organization within six months of being granted registration.

(D) Each such person must include with such financial report a statement describing the source of his current assets and representing that his capital has been contributed for the purpose of operating his business and will continue to be used for such purpose.

(ii) * * *

(C) A Form 1–FR–IB as of a date not more than 17 business days prior to the date on which such report is filed, *Provided, however,* that such applicant shall be subject to a review by the applicant's designated self-regulatory organization within six months of registration; or

(D) A guarantee agreement.

(E) Each person filing in accordance with paragraphs (a)(2)(ii) (A), (B) or (C) of this section must include with such financial report a statement describing the source of his current assets and representing that his capital has been contributed for the purpose of operating his business and will continue to be used for such purpose.

* * * * *

4. Section 1.17 is amended by redesignating paragraph (a)(1)(ii) as (a)(1)(iii) and by adding new paragraphs (a)(1)(ii) and (a)(2)(iii) to read as follows:

§ 1.17 Minimum financial requirements for futures commission merchants and introducing brokers.

(a) * * *

(1) * * *

(ii) Each person registered as a futures commission merchant engaged in soliciting or accepting orders and customer funds related thereto for the purchase or sale of any commodity for future delivery on or subject to the rules of a derivatives transaction facility from any customer who does not qualify as an ''institutional customer'' as defined in § 1.3(g):

(A) Must be a clearing member of a designated contract market or recognized futures exchange, and must maintain adjusted net capital in the amount of the greater of $20,000,000 or the amounts otherwise specified in paragraph (a)(1)(i) of this section; or

(B) Receive orders on behalf of the customer from a commodity trading advisor acting in accordance with § 4.32 of this chapter.

* * * * *

(2) * * *

(iii) The requirements of paragraph (a)(1) of this section shall not be applicable if the registrant is a futures commission merchant or introducing broker registered in accordance with § 3.10(a)(1)(i)(B) of this chapter, whose business is limited to transacting business on behalf of institutional customers on a derivatives transaction facility, and who conforms to minimum financial standards and related reporting requirements set by such derivatives transaction facility in its rules.

* * * * *

5. Section 1.20 is amended by revising paragraphs (a) and (c) to read as follows:

§ 1.20 Customer funds to be segregated and separately accounted for.

(a) All customer funds shall be separately accounted for and segregated as belonging to commodity or option customers. Such customer funds when deposited with any bank, trust company, clearing organization or another futures commission merchant shall be deposited under an account name which clearly identifies them as such and shows that they are segregated as required by the Act and this part. Each registrant shall obtain and retain in its files for the period provided in § 1.31 a written acknowledgment from such bank, trust company, clearing organization, or futures commission merchant, that it was informed that the customer funds deposited therein are those of commodity or option customers and are being held in accordance with the provisions of the Act and this part: *Provided, however,* that an acknowledgment need not be obtained from a clearing organization that has adopted and submitted to the Commission rules that provide for the segregation as customer funds, in accordance with all relevant provisions of the Act and the rules and orders promulgated thereunder, of all funds held on behalf of customers. Under no circumstances shall any portion of customer funds be obligated to a clearing organization, any member of a contract market, a futures commission merchant, or any depository except to purchase, margin, guarantee, secure, transfer, adjust or settle trades, contracts or commodity option transactions of commodity or option customers. No person, including any clearing organization or any depository, that has received customer funds for deposit in a segregated account, as provided in this section, may hold, dispose of, or use any such funds as belonging to any person other than the option or commodity customers of the futures commission merchant which deposited such funds.

* * * * *

(c) Each futures commission merchant shall treat and deal with the customer funds of a commodity customer or of an option customer as belonging to such commodity or option customer. All customer funds shall be separately accounted for, and shall not be commingled with the money, securities or property of a futures commission merchant or of any other person, or be used to secure or guarantee the trades, contracts or commodity options, or to secure or extend the credit, of any person other than the one for whom the same are held: *Provided, however,* That customer funds treated as belonging to the commodity or option customers of a futures commission merchant may for convenience be commingled and deposited in the same account or accounts with any bank or trust company, with another person registered as a futures commission merchant, or with a clearing organization, and that such share thereof as in the normal course of business is necessary to purchase, margin, guarantee, secure, transfer, adjust, or settle the trades, contracts or commodity options of such commodity or option customers or resulting market positions, with the clearing organization or with any other person registered as a futures commission merchant, may be withdrawn and applied to such purposes, including the payment of premiums to option grantors, commissions, brokerage, interest, taxes, storage and other fees and charges, lawfully accruing in connection with such trades, contracts or commodity options: *Provided, further,* That customer funds may be invested in instruments described in § 1.25.

6. Section 1.25 is revised to read as follows:

§ 1.25 Investment of customer funds.

(a) *Permitted investments.* (1) Subject to the terms and conditions set forth in this section, a futures commission merchant or a clearing organization may invest customer funds in the following instruments (permitted investments):

(i) Obligations of the United States and obligations fully guaranteed as to principal and interest by the United States (U.S. government securities);

(ii) General obligations of any State or of any political subdivision thereof (municipal securities);

(iii) General obligations issued by any agency sponsored by the United States (government sponsored agency securities);

(iv) Certificates of deposit issued by a bank (certificates of deposit) as defined in section 3(a)(6) of the Securities Exchange Act of 1934, or a domestic branch of a foreign bank that carries deposits insured by the Federal Deposit Insurance Corporation;

(v) Commercial paper;

(vi) Corporate notes;

(vii) General obligations of any country whose sovereign debt is rated in the highest category by at least one nationally recognized statistical rating organization (NRSRO), as that term is defined in § 270.2a–7 of this title (permitted foreign sovereign debt), subject to the following limits: a futures commission merchant may invest in the sovereign debt of a country to the extent it has balances in segregated accounts owed to its customers denominated in that country's currency; a clearing organization may invest in the sovereign debt of a country to the extent it has balances in segregated accounts owed to its clearing member futures commission merchants denominated in that country's currency; and

(viii) Interests in money market mutual funds.

(2) In addition, a futures commission merchant or a clearing organization may buy and sell the permitted investments listed in paragraphs (a)(1)(i) through (viii) of this section pursuant to agreements for resale or repurchase of the instruments, in accordance with the provisions of paragraph (d) of this section.

(b) *General terms and conditions.* A futures commission merchant or a clearing organization is required to manage the permitted investments consistent with the objectives of preserving principal and maintaining liquidity and according to the following specific requirements.

(1) *Marketability.* Except for interests in money market mutual funds, investments must be ''readily marketable'' as defined in § 240.15c3–1 of this title.

(2) *Ratings.* (i) *Initial requirement.* Instruments that are required to be rated by this section must be rated by an NRSRO. For an investment to qualify as a permitted investment, ratings are required as follows:

(A) U.S. government securities and the permitted sovereign debt of the countries listed in paragraph (a)(1)(vii) of this section, need not be rated;

(B) Municipal securities, government sponsored agency securities, certificates of deposit, commercial paper, and corporate notes, except notes that are asset-backed, must have the highest short-term rating of an NRSRO or one of the two highest long-term ratings of an NRSRO;

(C) Corporate notes that are asset-backed must have the highest rating of an NRSRO; and

(D) Money market mutual funds that are rated by an NRSRO must be rated at the highest rating of the NRSRO.

(ii) *Effect of downgrade.* If an NRSRO lowers the rating of an instrument that was previously a permitted investment on the basis of that rating to below the minimum rating required under this section, the value of the instrument recognized for segregation purposes will be the lesser of:

(A) The current market value of the instrument; or

(B) The market value of the instrument on the business day preceding the downgrade, reduced by 20 percent of that value for each business day that has elapsed since the downgrade.

(3) *Restrictions on instrument features.* (i) With the exception of money market mutual funds, no permitted investment may contain an embedded derivative of any kind, including but not limited to a call option, put option, or collar, cap, or floor on interest paid.

(ii) No instrument may contain interest-only payment features.

(iii) No instrument may provide payments linked to a commodity, currency, reference instrument, index, or benchmark except as provided in paragraph (b)(3)(iv) of this section.

(iv) Variable-rate securities are permitted, provided the interest rates paid correlate closely and on an unleveraged basis to a benchmark of either the Federal Funds target or effective rate, the prime rate, the three-month Treasury Bill rate, or the one-month or three-month LIBOR rate.

(v) Certificates of deposit, if negotiable, must be able to be liquidated within one business day or, if not negotiable, must be redeemable at the issuing bank within one business day, with any penalty for early withdrawal limited to any accrued interest earned according to its written terms.

(4) *Concentration.* (i) *Direct investments.* (A) U.S. government securities, money market mutual funds, and permitted foreign sovereign debt securities shall not be subject to a concentration limit.

(B) Securities of any single issuer of government sponsored agency securities held by a futures commission merchant or clearing organization may not exceed 25 percent of total assets held in segregation by the futures commission merchant or clearing organization.

(C) Securities of any single issuer of municipal securities, certificates of deposit, commercial paper, or corporate notes held by a futures commission merchant or clearing organization may not exceed 5 percent of total assets held in segregation by the futures commission merchant or clearing organization.

(ii) *Repurchase agreements.* For purposes of determining compliance with the concentration limits set forth in this section, securities sold by a futures commission merchant or clearing organization subject to agreements to repurchase shall be combined with securities held by the futures commission merchant or clearing organization as direct investments.

(iii) *Reverse repurchase agreements.* The concentration limit applicable to securities of each issuer that are held by a futures commission merchant or clearing organization subject to agreements to resell to a particular counterparty shall be as follows:

(A) For a portfolio of securities held that are subject to resale to a counterparty that has been rated single A or higher by two or more NRSROs, or whose obligation under an agreement is guaranteed by a parent or affiliate company that has been rated single A or higher by two or more NRSROs:

(*1*) Government sponsored agency debt, issued by the same issuer and supplied by the counterparty, may not exceed 50 percent of the total amount of securities supplied by such counterparty; and

(*2*) Municipal securities, certificates of deposit, commercial paper, and corporate notes, issued by the same issuer and supplied by the counterparty, may not exceed 10 percent of the total amount of securities supplied by such counterparty; and

(B) For a portfolio of securities held that are subject to resale to a counterparty that does not have a rating or guarantee as specified in paragraph (b)(4)(iii)(A) of this section:

(*1*) Government sponsored agency debt, issued by the same issuer and supplied by the counterparty, may not exceed 25 percent of the total amount of securities supplied by such counterparty; and

(*2*) Municipal securities, certificates of deposit, commercial paper, and corporate notes, issued by the same issuer and supplied by the counterparty, may not exceed 5 percent of the total amount of securities supplied by such counterparty.

(iv) *Treatment of securities issued by affiliates.* For purposes of determining compliance with the concentration limits set forth in this section, securities issued by entities that are affiliated, as defined in paragraph (b)(6) of this section, shall be aggregated and deemed the securities of a single issuer. An interest in a permitted money market mutual fund is not deemed to be a security issued by its sponsoring entity.

(v) *Treatment of customer-owned securities.* For purposes of determining compliance with the concentration limits set forth in this section, securities owned by the customers of a futures commission merchant and posted as margin collateral are not included in total assets held in segregation by the futures commission merchant, and securities posted by a futures commission merchant with a clearing organization are not included in total assets held in segregation by the clearing organization.

(5) *Time-to-maturity.* Except for investments in money market mutual funds, the dollar-weighted average of the time-to-maturity of the portfolio, as that average is computed pursuant to § 270.2a–7 of this title, may not exceed 24 months.

(6) *Investments in instruments issued by affiliates.* (i) A futures commission merchant shall not invest customer funds in obligations of an entity affiliated with the futures commission merchant, and a clearing organization shall not invest customer funds in obligations of an entity affiliated with the clearing organization. An affiliate includes parent companies, including all entities through the ultimate holding company, subsidiaries to the lowest level, and companies under common ownership of such parent company or affiliates.

(ii) A futures commission merchant or clearing organization may invest customer funds in a fund affiliated with that futures commission merchant or clearing organization.

(7) *Recordkeeping.* A futures commission merchant and a clearing organization shall prepare and maintain a record that will show for each business day with respect to each type of investment made pursuant to this section, the following information:

(i) The type of instruments in which customer funds have been invested;

(ii) The original cost of the instruments; and

(iii) The current market value of the instruments.

(c) *Money market mutual funds.* The following provisions will apply to the investment of customer funds in money market mutual funds (the fund).

(1) Generally, the fund must be an investment company that is registered under the Investment Company Act of 1940 with the Securities and Exchange Commission and that holds itself out to investors as a money market fund, in accordance with § 270.2a–7 of this title. A fund sponsor, however, may petition the Commission for an exemption from this requirement. The Commission may grant such an exemption provided that the fund can demonstrate that it will operate in a manner designed to preserve principal and to maintain liquidity. The application for exemption must describe how the fund's structure, operations and financial reporting are expected to differ from the requirements contained in § 270.2a–7 of this title and the risk-limiting provisions for direct investments contained in this section. The fund must also specify the information that the fund would make available to the Commission on an ongoing basis.

(2) The fund must be sponsored by a federally-regulated financial institution, a bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934, an investment adviser registered under the Investment Advisers Act of 1940, or a domestic branch of a foreign bank insured by the Federal Deposit Insurance Corporation, except for a fund exempted in accordance with paragraph (c)(1) of this section.

(3) A futures commission merchant or clearing organization shall maintain the confirmation relating to the purchase in its records in accordance with § 1.31 and note the ownership of fund shares (by book-entry or otherwise) in a custody account of the FCM or clearing organization in accordance with § 1.26(a). If the futures commission merchant or the clearing organization holds its shares of the fund with the fund's shareholder servicing agent, the sponsor of the fund and the fund itself are required to provide the acknowledgment letter required by § 1.26.

(4) The net asset value of the fund must be computed by 9 a.m. of the business day following each business day and made available to the futures commission merchant or clearing organization by that time.

(5) A fund must be able to redeem an interest by the business day following a redemption request by the futures commission merchant or clearing organization. Demonstration that this requirement has been met may include either an appropriate provision in the offering memorandum of the fund or a separate side agreement between the fund and a futures commission merchant or clearing organization.

(6) The agreement pursuant to which the futures commission merchant or clearing organization has acquired and is holding its interest in a fund must contain no provision that would prevent the pledging or transferring of shares.

(d) *Repurchase and reverse repurchase agreements.* A futures commission merchant or clearing organization may buy and sell the permitted investments listed in paragraphs (a)(1)(i) through (viii) of this section pursuant to agreements for resale or repurchase of the securities (agreements to repurchase or resell), provided the agreements to repurchase or resell conform to the following requirements:

(1) The securities are specifically identified by coupon rate, par amount, market value, maturity date, and CUSIP or ISIN number.

(2) Counterparties are limited to a bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934, a domestic branch of a foreign bank insured by the Federal Deposit Insurance Corporation, a securities broker or dealer, or a government securities broker or government securities dealer registered with the Securities and Exchange Commission or which has filed notice pursuant to section 15C(a) of the Government Securities Act of 1986.

(3) The transaction is executed in compliance with the concentration limit requirements applicable to the securities held in connection with the agreements to repurchase referred to in paragraphs (b)(4)(ii) and (iii) of this section.

(4) The transaction is made pursuant to a written agreement signed by the parties to the agreement, which is consistent with the conditions set forth in paragraphs (d)(1) through (d)(12) of this section and which states that the

parties thereto intend the transaction to be treated as a purchase and sale of securities.

(5) The term of the agreement is no more than one business day, or reversal of the transaction is possible on demand.

(6) The securities transferred under the agreement are held in a safekeeping account with a bank as referred to in paragraph (d)(2) of this section, a clearing organization, or the Depository Trust Company in an account that complies with the requirements of § 1.26.

(7) The futures commission merchant or the clearing organization may not use securities received under the agreement in another similar transaction and may not otherwise hypothecate or pledge such securities, except securities may be pledged on behalf of customers at another futures commission merchant or clearing organization. Substitution of securities is allowed, *provided, however,* that:

(i) The qualifying securities being substituted and original securities are specifically identified by date of substitution, market values substituted, coupon rates, par amounts, maturity dates and CUSIP or ISIN numbers;

(ii) Substitution is made on a ''delivery versus delivery'' basis; and

(iii) The market value of the substituted securities is at least equal to that of the original securities.

(8) The transfer of securities is made on a delivery versus payment basis in immediately available funds. The transfer is not recognized as accomplished until the funds and/or securities are actually received by the custodian of the futures commission merchant's or clearing organization's customer funds or securities purchased on behalf of customers. The transfer or credit of securities covered by the agreement to the futures commission merchant's or clearing organization's customer segregated custodial account is made simultaneously with the disbursement of funds from the futures commission merchant's or clearing organization's customer segregated cash account at the custodian bank. On the sale or resale of securities, the futures commission merchant's or clearing organization's customer segregated cash account at the custodian bank must receive same-day funds credited to such segregated account simultaneously with the delivery or transfer of securities from the customer segregated custodial account.

(9) A written confirmation to the futures commission merchant or clearing organization specifying the terms of the agreement and a safekeeping receipt are issued immediately upon entering into the transaction and a confirmation to the futures commission merchant or clearing organization is issued once the transaction is reversed.

(10) The transactions effecting the agreement are recorded in the record required to be maintained under § 1.27 of investments of customer funds, and the securities subject to such transactions are specifically identified in such record as described in paragraph (d)(1) of this section and further identified in such record as being subject to repurchase and reverse repurchase agreements.

(11) An actual transfer of securities by book entry is made consistent with Federal or State commercial law, as applicable. At all times, securities received subject to an agreement are reflected as ''customer property.''

(12) The agreement makes clear that, in the event of the bankruptcy of the futures commission merchant or clearing organization, any securities purchased with customer funds that are subject to an agreement may be immediately transferred. The agreement also makes clear that, in the event of a futures commission merchant or clearing organization bankruptcy, the counterparty has no right to compel liquidation of securities subject to an agreement or to make a priority claim for the difference between current market value of the securities and the price agreed upon for resale of the securities to the counterparty, if the former exceeds the latter.

(e) *Deposit of firm-owned securities into segregation.* A futures commission merchant shall not be prohibited from directly depositing unencumbered securities of the type specified in this section, which it owns for its own account, into a segregated safekeeping account or from transferring any such securities from a segregated account to its own account, up to the extent of its residual financial interest in customers' segregated funds; provided, however, that such investments, transfers of securities, and disposition of proceeds from the sale or maturity of such securities are recorded in the record of investments required to be maintained by § 1.27. All such securities may be segregated in safekeeping only with a bank, trust company, clearing organization, or other registered futures commission merchant. Furthermore, for purposes of §§ 1.25, 1.26, 1.27, 1.28 and 1.29, investments permitted by § 1.25 that are owned by the futures commission merchant and deposited into such a segregated account shall be considered customer funds until such investments are withdrawn from segregation.

7. Section 1.26 is revised to read as follows:

§ 1.26 Deposit of instruments purchased with customer funds.

(a) Each futures commission merchant who invests customer funds in instruments described in § 1.25 shall separately account for such instruments and segregate such instruments as belonging to such commodity or option customers. Such instruments, when deposited with a bank, trust company, clearing organization or another futures commission merchant, shall be deposited under an account name which clearly shows that they belong to commodity or option customers and are segregated as required by the Act and this part. Each futures commission merchant upon opening such an account shall obtain and retain in its files an acknowledgment from such bank, trust company, clearing organization or other futures commission merchant that it was informed that the instruments belong to commodity or option customers and are being held in accordance with the provisions of the Act and this part. *Provided, however,* that an acknowledgment need not be obtained from a clearing organization that has adopted and submitted to the Commission rules that provide for the segregation as customer funds, in accordance with all relevant provisions of the Act and the rules and orders promulgated thereunder, of all funds held on behalf of customers and all instruments purchased with customer funds. Such acknowledgment shall be retained in accordance with § 1.31. Such bank, trust company, clearing organization or other futures commission merchant shall allow inspection of such obligations at any reasonable time by representatives of the Commission.

(b) Each clearing organization which invests money belonging or accruing to commodity or option customers of its clearing members in instruments described in § 1.25 shall separately account for such instruments and segregate such instruments as belonging to such commodity or option customers. Such instruments, when deposited with a bank or trust company, shall be deposited under an account name which will clearly show that they belong to commodity or option customers and are segregated as required by the Act and this part. Each clearing organization upon opening such an account shall obtain and retain in its files a written acknowledgment from such bank or trust company that it was informed that the instruments belong to commodity or option customers of clearing members and are being held in accordance with the provisions of the Act and this part. Such acknowledgment shall be retained in accordance with § 1.31. Such bank or trust company shall allow inspection of such instruments at any reasonable time by representatives of the Commission.

§ 1.27 [Amended]

8. Section 1.27 is amended by:

a. Revising the word ''obligations'' to read ''instruments'' each time it appears; and

b. Adding the phrase ''or ISIN'' following the word ''CUSIP'' each time it appears.

§§ 1.28 and 1.29 [Amended]

9. Sections 1.28 and 1.29 are amended by revising the word ''obligations'' to read ''instruments'' each time it appears.

10. Section 1.33 is amended by adding a new paragraph (g) to read as follows:

§ 1.33 Monthly and confirmation statements.

* * * * *

(g) *Electronic transmission of statements.* (1) The statements required by this section, and by § 1.46, may be furnished to any customer by means of electronic media if the customer so requests, *Provided, however,* that a futures commission merchant must, prior to the transmission of any statement by means of electronic media, disclose the electronic medium or source through which statements will be delivered, the duration, whether indefinite or not, of the period during which consent will be effective, any charges for such service, the information that will be delivered by such means, and that consent to electronic delivery may be revoked at any time.

(2) In the case of a customer who does not qualify as an ''institutional customer'' as defined in § 1.3(g), a futures commission merchant must obtain the customer's signed consent acknowledging disclosure of the information set forth in paragraph (g)(1) of this section prior to the transmission of any statement by means of electronic media.

(3) Any statement required to be furnished to a person other than a customer in accordance with paragraph (d) of this section may be furnished by electronic media.

(4) A futures commission merchant who furnishes statements to any customer by means of electronic media must retain a daily confirmation statement for such customer as of the end of the trading session, reflecting all transactions made during that session for the customer, in accordance with § 1.31.

* * * * *

11. Section 1.46 is amended as follows:

a. By revising paragraph (a), introductory text,

b. By removing and reserving paragraphs (d)(4) through (d)(7),

c. By removing paragraph (d)(9) and

d. By revising paragraph (e) to read as follows:

§ 1.46 Application and closing out of offsetting long and short positions.

(a) *Application of purchases and sales.* Except with respect to purchases or sales which are for omnibus accounts, or where the customer has instructed otherwise, any futures commission merchant who, on or subject to the rules of a contract market, recognized futures exchange or derivatives transaction facility:

* * * * *

(e) The statements required by paragraph (a) of this section may be furnished to the customer or the person described in § 1.33(d) by means of electronic transmission, in accordance with § 1.33(g).

* * * * *

12. Section 1.52 is amended by adding a new paragraph (m) to read as follows:

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

* * * * *

(m) Nothing in this section shall apply to the activities of a derivatives transaction facility or the minimum adjusted net capital requirements it may require of persons operating thereon pursuant to § 1.17(a)(2)(iii).

* * * * *

13. Section 1.55 is amended by revising paragraphs (d) and (f) to read as follows:

§ 1.55 Distribution of ''Risk Disclosure Statement'' by futures commission merchants and introducing brokers.

* * * * *

(d) Any futures commission merchant, or in the case of an introduced account any introducing broker, may open a commodity futures account for a customer without obtaining the separate acknowledgments of disclosure and elections required by this section and by § 1.33(g), and by §§ 33.7, 155.3(b)(2), and 190.06 of this chapter, provided that:

(1) Prior to the opening of such account, the futures commission merchant or introducing broker obtains an acknowledgment from the customer, which may consist of a single signature at the end of the futures commission merchant's or introducing broker's customer account agreement, or on a separate page, of the disclosure statements and elections specified in this section and § 1.33(g), and in §§ 33.7, 155.3(b)(2), and 190.06 of this chapter, and which may include authorization for the transfer of funds from a segregated customer account to another account of such customer, as listed directly above the signature line, provided the customer has acknowledged by check or other indication next to a description of each specified disclosure statement or election that the customer has received and understood such disclosure statement or made such election;

(2) The acknowledgment referred to in paragraph (d)(1) of this section must be accompanied by and executed contemporaneously with delivery of the disclosures and elective provisions required by this section and § 1.33(g), and by §§ 33.7, 155.3(b)(2), and 190.06 of this chapter.

* * * * *

(f) A futures commission merchant or, in the case of an introduced account an introducing broker, may open a commodity futures account for an institutional customer without furnishing such institutional customer the disclosure statements or obtaining the acknowledgements required under paragraph (a) of this section, §§ 1.33(g) and 1.65(a)(3), and §§ 30.6(a), 33.7(a), 155.3(b)(2), and 190.10(c) of this chapter.

* * * * *

PART 3—REGISTRATION

14. The authority citation for Part 3 is revised to read as follows:

Authority: 5 U.S.C. 522, 522b; 7 U.S.C. 1a, 2, 4, 4a, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6k, 6m, 6n, 6o, 6p, 8, 9, 9a, 12, 12a, 13b, 13c, 16a, 18, 19, 21, 23.

15. Section 3.1 is amended by revising paragraphs (a)(1) and (a)(2) to read as follows:

§ 3.1 Definitions.

(a) * * *

(1) If the entity is organized as a sole proprietorship, the proprietor; if a partnership, any general partner; if a corporation, any director, the president, chief executive officer, chief operating officer, chief financial officer, and any person in charge of a principal business

unit, division or function subject to regulation by the Commission; if a limited liability company or limited liability partnership, any director, the president, chief executive officer, chief operating officer, chief financial officer, the manager, managing member or those members vested with the management authority for the entity, and any person in charge of a principal business unit, division or function subject to regulation by the Commission; and, in addition, any person occupying a similar status or performing similar functions, having the power, directly or indirectly, through agreement or otherwise, to exercise a controlling influence over the entity's activities that are subject to regulation by the Commission;

(2)(i) Any individual who directly or indirectly, through agreement, holding company, nominee, trust or otherwise, is the owner of ten percent or more of the outstanding shares of any class of stock, is entitled to vote or has the power to sell or direct the sale of ten percent or more of any class of voting securities, or is entitled to receive ten percent or more of the profits; or

(ii) Any person other than an individual that is the direct owner of ten percent or more of any class of securities; or

* * * * *

16. Section 3.10 is amended by revising paragraph (a)(1)(i), by redesignating paragraph (a)(2)(i) as paragraph (a)(2), by removing paragraph (a)(2)(ii), and by revising paragraph (d) to read as follows:

§ 3.10 Registration of futures commission merchants, introducing brokers, commodity trading advisors, commodity pool operators and leverage transaction merchants.

(a) *Application for registration.* (1)(i)(A) Except as provided in paragraph (a)(1)(i)(B) of this section, application for registration as a futures commission merchant, introducing broker, commodity trading advisor, commodity pool operator or leverage transaction merchant must be on Form 7–R, completed and filed with the National Futures Association in accordance with the instructions thereto.

(B) An applicant for registration as a futures commission merchant or introducing broker that will conduct transactions on or subject to the rules of a contract market, recognized futures exchange or derivatives transaction facility for institutional customers, and which is registered with the Securities and Exchange Commission as a securities broker or dealer, or is a bank or any other financial depository institution subject to regulation by the United States, may apply for registration by filing with the National Futures Association notice of its intention to undertake transactions on or subject to the rules of a contract market, recognized futures exchange, or derivatives transaction facility for institutional customers, together with a certification of registration and good standing with the appropriate authority or of authorization to engage in such transactions by said authority.

* * * * *

(d) *Annual filing.* Any person registered as a futures commission merchant, introducing broker, commodity trading advisor, commodity pool operator or leverage transaction merchant in accordance with paragraph (a)(1)(i)(A) of this section must file with the National Futures Association a Form 7–R, completed in accordance with the instructions thereto, annually on a date specified by the National Futures Association. The failure to file the Form 7–R within thirty days following such date shall be deemed to be a request for withdrawal from registration. On at least thirty days written notice, and following such action, if any, deemed to be necessary by the Commission or the National Futures Association, the National Futures Association may grant the request for withdrawal from registration.

* * * * *

17. Section 3.21 is amended by revising paragraph (c) introductory text to read as follows:

§ 3.21 Exemption from fingerprinting requirement in certain cases.

* * * * *

(c) *Outside directors.* Any futures commission merchant, introducing broker, commodity trading advisor, commodity pool operator or leverage transaction merchant that has a principal who is a director but is not also an officer or employee of the firm may, in lieu of submitting a fingerprint card in accordance with the provisions of §§ 3.10(a)(2)(i) and 3.31(a)(2), file a ''Notice Pursuant to Rule 3.21(c)'' with the National Futures Association. Such notice shall state, if true, that such outside director:

* * * * *

18. Section 3.31 is amended by redesignating paragraph (a) as paragraph (a)(1), and by adding new paragraph (a)(2) to read as follows:

§ 3.31 Deficiencies, inaccuracies, and changes, to be reported.

(a) * * *

(1) * * *

(2) Where the deficiency or inaccuracy is created by the addition of a new principal not listed on the registrant's application for registration (or amendment of such application prior to the granting of registration), each Form 3–R filed in accordance with the requirements of paragraph (a)(1) of this section must be accompanied by a Form 8–R, completed in accordance with the instructions thereto and executed by each natural person who is a principal of the registrant and who was not listed on the registrant's initial application for registration or any amendment thereto. The Form 8–R for each such principal must be accompanied by the fingerprints of that principal on a fingerprint card provided by the National Futures Association for that purpose, unless such principal is a director who qualifies for the exemption from the fingerprint requirement pursuant to § 3.21(c). The provisions of this paragraph do not apply to any principal who has a current Form 8–R on file with the Commission or the National Futures Association.

* * * * *

§ 3.32 [Removed]

19. Section 3.32 is removed.

§ 3.34 [Removed]

20. Section 3.34 is removed.

21. Appendix A to Part 3 is amended by adding to the end thereto the following:

Appendix A to Part 3—Interpretive Statement with Respect to Section 8A(2)(C) and (E) and Section 8A(3)(J) and (M) of the Commodity Exchange Act

* * * * *

The Commission has further addressed ''other good cause'' under Section 8a(3)(M) of the Act in issuing guidance letters on assessing the fitness of floor brokers, floor traders or applicants in either category:

[First guidance letter]

December 4, 1997.

Robert K. Wilmouth,

President, National Futures Association, 200 West Madison Street, Chicago, IL.

Re: Adverse Registration Actions with Respect to Floor Brokers, Floor Traders and Applicants for Registration in Either Category

Dear Mr. Wilmouth:

As you know, the Commission on June 26, 1997, approved for publication in the **Federal Register** a Notice and Order concerning adverse registration actions by the National Futures Association (''NFA'') with respect to registered floor brokers (''FBs''), registered floor traders (''FTs'') and applicants for registration in either category. 62 Fed. Reg. 36050 (July 3, 1997). The Notice and Order authorized NFA to grant or to maintain, either with or without conditions or restrictions, FB or FT registration where NFA previously would have forwarded the case to the Commission for review of disciplinary history. The Commission has worked with its staff to determine which of the pending matters could efficiently be returned to NFA for handling, and such matters have been forwarded to NFA. The Commission will continue to accept or to act upon requests for exemption, and the Commission staff will consider requests for ''no-action'' opinions with respect to applicable registration requirements.

By this correspondence, the Commission is issuing guidance that provides NFA further direction on how it expects NFA to exercise its delegated power, based upon the experience of the Commission and the staff with the registration review process during the past three years. This guidance will help ensure that NFA exercises its delegated power in a manner consistent with Commission precedent.

In exercising its delegated authority, NFA, of course, needs to apply all of the provisions of Sections 8a(2) and (3) of the Commodity Exchange Act (''Act'').[1] In that regard, NFA should consider the matters in which the Commission has taken action in the past and endeavor to seek similar registration restrictions, conditions, suspensions, denials, or revocations under similar circumstances.

One of the areas in which NFA appears to have had the most uncertainty is with regard to previous self-regulatory organization (''SRO'') disciplinary actions. Commission Rule 1.63[2] provides clear guidelines for determining whether a person's history of ''disciplinary offenses'' should preclude service on SRO governing boards or committees.[3] In determining whether to grant or to maintain, either with or without conditions or restrictions, FB or FT registration, NFA should, as an initial matter, apply the Rule 1.63(a)(6) criteria to those registered FBs, registered FTs and applicants for registration in either category. However, NFA should be acting based upon any such offenses that occurred within the previous five years, rather than the three years provided for in Rule 1.63(c). NFA should consider disciplinary actions taken by an SRO as that term is defined in Section 3(a)(26) of the Securities Exchange Act of 1934 no differently from disciplinary actions taken by an SRO in the futures industry as defined in Rule 1.3(ee).[4] Application of the Rule 1.63 criteria, as modified, to these matters will aid NFA in making registration determinations that are reasonably consonant with Commission views.[5] NFA should focus on the nature of the underlying conduct rather than the sanction imposed by an SRO. Thus, if a disciplinary action would not come within the coverage of Rule 1.63 but for the imposition of a short suspension of trading privileges (such as for a matter involving fighting, use of profane language or minor recordkeeping violations), NFA could exercise discretion, as has the Commission, not to institute a statutory disqualification case. On the other hand, conduct that falls clearly within the terms of Rule 1.63, such as violations of rules involving potential harm to customers of the exchange, should not be exempt from review simply because the exchange imposed a relatively minor sanction.

The Commission has treated the registration process and the SRO disciplinary process as separate matters involving separate considerations. The fact that the Commission has not pursued its own enforcement case in a particular situation does not necessarily mean that the Commission considers the situation to be a minor matter for which no registration sanctions are appropriate. Further, the Commission believes that it and NFA, entities with industry-wide perspective and responsibilities, are the appropriate bodies, rather than any individual exchange, to decide issues relating to registration status, which can affect a person's ability to function in the industry well beyond the jurisdiction of a particular exchange. Thus, NFA's role is in no way related to review of exchange sanctions for particular conduct, but rather it is the entirely separate task of determining whether an FB's or FT's conduct should impact his or her registration.

NFA also should look to Commission precedent in selecting conditions or restrictions to be imposed, such as a dual trading ban where a person has been involved in disciplinary offenses involving customer abuse. Where conditions or restrictions are imposed, or agreed upon, NFA also should follow Commission precedent, under which such conditions or restrictions generally have been imposed for a two-year period.

The Commission has required sponsorship for conditioned FBs and FTs when their disciplinary offenses have involved noncompetitive trading and fraud irrespective of the level of sanctions imposed by an SRO. Indeed, but for a sponsorship requirement there would be no one routinely watching and responsible for the activities of these registrants. Absent sponsorship, such FBs and FTs would only be subject to routine Commission and exchange surveillance. The Commission's rules are premised upon the judgment that requiring FTs and FBs to have sponsors to ensure their compliance with conditions is both appropriate and useful. See Rule 3.60(b)(2)(i).

A question has arisen whether, if NFA is required to prove up the underlying facts of an SRO disciplinary action, the exchanges can provide information on exchange disciplinary proceedings directly to NFA. Although Section 8c(a)(2) of the Act states that an exchange shall not disclose the evidence for a disciplinary action except to the person disciplined and to the Commission, Section 8a(10) of the Act allows the Commission to authorize any person to perform any portion of the registration functions under the Act, notwithstanding any other provision of law. The effective discharge of the delegated registration function requires NFA to have access to the exchange evidence. Thus, the Commission believes that Section 8a(10) may reasonably be interpreted to allow the disclosure of information from exchange disciplinary proceedings directly to NFA despite the provisions of Section 8c(a)(2).

Nothing in the Notice and Order affects the Commission's authority to review the granting of a registration application by NFA in the performance of Commission registration functions, including review of the sufficiency of conditions or restrictions imposed by NFA, to review the determination by NFA not to take action to affect an existing registration, or to take its own action to address a statutory disqualification. Moreover, the Commission Order contemplates that to allow for appropriate Commission oversight of NFA's exercise of this delegated authority, NFA will provide for the Commission's review quarterly schedules of all applicants cleared for registration and all registrants whose registrations are maintained without adverse action by NFA's Registration, Compliance, Legal Committee despite potential statutory disqualifications.

The Commission will continue to monitor NFA activities through periodic rule enforcement reviews, and NFA remains subject to the present requirement that it

[1] 7 U.S.C. 12a(2) and (3) (1994). The letter is intended to supplement, not to supersede, other guidance provided in the past to NFA. In this regard, the NFA should continue to follow other guidance provided by the Commission or its staff.

[2] Commission rules referred to herein are found at 17 CFR Ch. I.

[3] Rule 1.63(c) provides that a person is ineligible from serving on an SRO's disciplinary committees, arbitration panels, oversight panels or governing board if, as provided in Rule 1.63(b), the person, inter alia: (1) within the past three years has been found by a final decision of an SRO, an administrative law judge, a court of competent jurisdiction or the Commission to have committed a disciplinary offense; or (2) within the past three years has entered into a settlement agreement in which any of the findings or, in the absence of such findings, any of the acts charged included a disciplinary offense.

Rule 1.63(a)(6) provides that a ''disciplinary offense'' includes: (i) any violation of the rules of an SRO except those rules related to (A) decorum or attire, (B) financial requirements, or (C) reporting or record-keeping unless resulting in fines aggregating more than $5,000 within any calendar year; (ii) any rule violation described in subparagraphs (A) through (C) above that involves fraud, deceit or conversion or results in a suspension or expulsion; (iii) any violation of the Act or the regulations promulgated thereunder; or (iv) any failure to exercise supervisory responsibility with respect to an act described in paragraphs (i) through (iii) above when such failure is itself a violation of either the rules of an SRO, the Act or the regulations promulgated thereunder.

[4] Thus, for example, a disciplinary action taken by the Chicago Board Options Exchange or the National Association of Securities Dealers, Inc. should be considered in a manner similar to a disciplinary action of the Chicago Board of Trade or NFA.

[5] In reviewing these matters, the NFA should bear in mind recent Commission precedent which allows for reliance on settled disciplinary proceedings in some circumstances. *See In the Matter of Michael J. Clark,* [1996–1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,032 (Apr. 22, 1997) (''other good cause'' under Section 8a(3)(M) of the Act exists based upon a pattern of exchange disciplinary actions resulting in significant sanctions for serious rule violations—whether settlements or adjudications), *aff'd sub nom., Clark v. Commodity Futures Trading Commission,* No. 97–4228 (2d Cir. June 4, 1999) (unpublished).

monitor compliance with the conditions and restrictions imposed on conditioned and restricted registrants.

Sincerely,

Jean A. Webb,

Secretary of the Commission.

[Second guidance letter]

April 13, 2000.

Robert K. Wilmouth,

President, National Futures Association, 200 West Madison Street, Chicago, IL.

Re: Use of Exchange Disciplinary Actions as *''Other Good Cause'' to Affect Floor Broker/Floor Trader Registration*

Dear Mr. Wilmouth:

I. Introduction and Background

In July 1997, the Commission issued a Notice and Order authorizing the National Futures Association (''NFA'') to grant or to maintain, either with or without conditions or restrictions, floor broker (''FB'') or floor trader (''FT'') registration where NFA previously would have forwarded the case to the Commission for review of disciplinary history.[1] By letter dated December 4, 1997 (''Guidance Letter''), the Commission provided further direction on how the Commission expected NFA to exercise its delegated power and to ensure that NFA exercised its delegated power in a manner consistent with Commission precedent.

The Commission has determined to revise the Guidance Letter. Specifically, the Commission is revising the portion of the Guidance Letter that addresses the use of exchange disciplinary actions as ''other good cause'' to affect FB and FT registrations. The Commission has made this determination following its own reconsideration of the issue and at the urging of industry members.[2]

The Guidance Letter pointed out that, in exercising its delegated authority, NFA must apply all of the provisions of Sections 8a(2) and (3) of the Commodity Exchange Act (''Act'').[3] In particular, Section 8a(3)(M) of the Act authorizes the Commission to refuse to register or to register conditionally any person if it is found, after opportunity for hearing, that there is other good cause for statutory disqualification from registration beyond the specifically listed grounds in Sections 8a(2) and 8a(3) of the Act. The Commission held in *In the Matter of Clark* that statutory disqualification under the ''other good cause'' provision of Section 8a(3)(M) may arise on the basis of, among other things, a pattern of exchange disciplinary actions alleging serious rule violations that result in significant sanctions, and that it is immaterial whether the sanctions imposed resulted from a fully-adjudicated disciplinary action or an action that was taken following a settlement.[4]

The Guidance Letter recommended the application of the provisions of Commission Rule 1.63 [5] as criteria to aid in assessing the impact of an FB or FT applicant's or registrant's previous disciplinary history on the person's fitness to be registered, with the exception that NFA should be acting based on disciplinary history from the previous five years, rather than the three years provided for in Rule 1.63.[6] The Guidance Letter also noted that NFA should consider disciplinary actions taken not only by futures industry SROs but also those taken by SROs as defined in Section 3(a)(26) of the Securities Exchange Act of 1934 (''1934 Act''), including settled disciplinary actions.

II. Revised Guidance

As stated above, the Commission has determined to revise the Guidance Letter. From this point forward, NFA should cease using Rule 1.63 as the basis to evaluate the impact of an FB or FT applicant's or registrant's disciplinary history on his or her fitness to be registered. Instead, as *Clark* stated, when reviewing disciplinary history to assess the fitness to be registered of an FB, FT, or applicant in either category, a pattern of exchange disciplinary actions alleging serious rule violations that result in significant sanctions will trigger the ''other good cause'' provision of Section 8a(3)(M). The ''pattern'' should consist of at least two final exchange disciplinary actions, whether settled or adjudicated.

NFA also should consider initiating proceedings to affect the registration of the FB or FT, even if there is only a single exchange action against the FB or FT, if the exchange action was based on allegations of particularly egregious misconduct or involved numerous instances of misconduct occurring over a long period of time. If, however, a proceeding is initiated based on a single exchange action that was disposed of by settlement, NFA may have to prove up the underlying misconduct. Furthermore, traditional principles of collateral estoppel apply to adjudicated actions, whether they are being considered individually or as part of a pattern.[7]

As provided by the Guidance Letter, ''exchange disciplinary actions'' would continue to include disciplinary actions taken by both futures industry SROs and SROs as defined in Section 3(a)(26) of the 1934 Exchange Act. Furthermore, NFA should review an applicant's or registrant's disciplinary history for the past five years.[8] At least one of the actions forming the pattern, however, must have become final after *Clark* was decided by the Commission on April 22, 1997. Finally, ''serious rule violations'' consist of, or are substantially related to, charges of fraud, customer abuse, other illicit trading practices, or the obstruction of an exchange investigation.

Congress, the courts and the Commission have indicated the importance of considering an applicant's history of exchange disciplinary actions in assessing that person's fitness to register.[9] Furthermore, NFA's review of exchange disciplinary actions within the context of the registration process should not simply mirror the disciplinary actions undertaken by the exchanges. The two processes are separate matters that involve separate considerations. As part of their ongoing self-regulatory obligations, exchanges must take disciplinary action [10] and such disciplinary matters necessarily focus on the specific misconduct that forms the allegation. In a statutory disqualification action, however, NFA must determine whether the disciplinary history of an FB, FT or applicant over the preceding five years should impact his or her registration. Additionally, NFA possesses industry-wide perspective and responsibilities. As such, NFA, rather than an individual exchange, should decide registration status issues, since those issues affect an individual's status

[1] Registration Actions by National Futures Association With Respect to Floor Brokers, Floor Traders and Applicants for Registration in Either Category, 62 FR 36050 (July 3, 1997).

[2] *See* letters submitted by James Bowe, former president of the New York Board of Trade (''NYBOT''), dated October 13, 1999, Christopher Bowen, general counsel of the New York Mercantile Exchange (''NYMEX''), dated October 18, 1999, and the Joint Compliance Committee (''JCC''), dated February 2, 2000. The JCC consists of senior compliance officials from all domestic futures exchanges and the NFA (*i.e.,* the domestic self-regulatory organizations (''SROs'')). In addition, staff from the Contract Markets Section of the Commission's Division of Trading and Markets attend the JCC meetings as observers. The JCC was established to aid in the development of improved compliance systems through joint efforts and information-sharing among the SROs. Commission staff have also discussed this issue with SRO staff.

[3] 7 U.S.C. 12a(2) and (3) (1994).

[4] *In the Matter of Clark,* [1996–1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,032 (Apr. 22, 1997), *aff'd sub nom., Clark* v. *Commodity Futures Trading Commission,* No. 97–4228 (2d Cir. June 4, 1999) (unpublished).

[5] Commission rules referred to in this letter are found at 17 CFR Ch. 1.

[6] Rule 1.63 provides, among other things, that a person is ineligible from serving on SRO disciplinary committees, arbitration panels, oversight panels or governing boards if that person, *inter alia,* entered into a settlement agreement within the past three years in which any of the findings or, in the absence of such findings, any of the acts charged included a disciplinary offense.

Rule 1.63(a)(6) defines a ''disciplinary offense'' to include:

(i) any violation of the rules of an SRO except those rules related to (A) decorum or attire, (B) financial requirements, or (C) reporting or record-keeping unless resulting in fines aggregating more than $5,000 within any calendar year; (ii) any rule violation described in subparagraphs (A) through (C) above that involves fraud, deceit or conversion or results in a suspension or expulsion; (iii) any violation of the Act or the regulations promulgated thereunder; or (iv) any failure to exercise supervisory responsibility with respect to an act described in paragraphs (i) through (iii) above when such failure is itself a violation of either the rules of an SRO, the Act or the regulations promulgated thereunder.

[7] *Clark* at 44,929.

[8] The Commission generally looked at a five-year period of disciplinary history. On occasion, however, the Commission examined a longer period of an applicant's or registrant's disciplinary history. For example, the Commission revoked the registration of one FB on the basis of exchange disciplinary cases that extended back six years, *see Clark,* 2 Comm. Fut. L. Rep. (CCH) ¶ 27,032, and denied an application for registration as an FT on the basis of exchange disciplinary cases that extended back seven years, *see In the Matter of Castellano,* [1987–1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,360 (Nov. 23, 1988), *summarily aff'd* (May 29, 1990), *reh. denied* [1990–1992 Transfer Binder] Comm. Fut. L. Rep. ¶ 24,870 (June 26, 1990), *aff'd sub nom. Castellano* v. *CFTC,* Docket No. 90–2298 (7th Cir. Nov. 20, 1991).

[9] Letter dated July 14, 1995, from Mary L. Schapiro to R. Patrick Thompson, President, New York Mercantile Exchange (unpublished). *See also Castellano, supra* note 8.

[10] *See* Rule 1.51(a)(7).

within the industry as a whole, well beyond the jurisdiction of a particular exchange.

The Commission also wants to clarify to the fullest extent possible that its power to delegate the authority to deny or condition the registration of an FB, FT, or an applicant for registration in either category permits exchanges to disclose to NFA all evidence underlying exchange disciplinary actions, notwithstanding the language of Section 8c(a)(2) of the Act.[11] The Commission's power to delegate stems from Section 8a(10) of the Act, which permits delegation of registration functions, including statutory disqualification actions, to any person in accordance with rules adopted by such person and submitted to the Commission for approval or for review under Section 17(j) of the Act, ''notwithstanding any other provision of law.'' Certainly, Section 8c(a)(2) qualifies as ''any other provision of law.'' Furthermore, the effective discharge of the delegated function requires NFA to have access to the exchange evidence. Thus, the exercise of the delegated authority pursuant to Section 8a(10) permits the exchanges to disclose all evidence underlying disciplinary actions to NFA.[12]

This letter supersedes the Guidance Letter to the extent discussed above. In all other aspects, the Guidance Letter and other guidance provided by the Commission or its staff remain in effect. Therefore, NFA should continue to follow Commission precedent when selecting conditions or restrictions to be imposed. For example, NFA should impose a dual trading ban where customer abuse is involved and any conditions or restrictions imposed should be for a two-year period. Furthermore, NFA should require sponsorship for conditioned FBs or FTs when their disciplinary offenses involve noncompetitive trading and fraud.

Nothing in the Notice and Order or this letter affects the Commission's authority to review the granting of a registration application by NFA in the performance of Commission registration functions, including review of the sufficiency of conditions or restrictions imposed by NFA, to review the determination by NFA not to take action to affect an existing registration, or to take its own action to address a statutory disqualification. Moreover, the Commission Order contemplates that to allow for appropriate Commission oversight of NFA's exercise of this delegated authority, NFA will provide for the Commission's review quarterly schedules of all applicants cleared for registration and all registrants whose registrations are maintained without adverse action by NFA's Registration, Compliance, Legal Committee despite potential statutory disqualifications.

The Commission will continue to monitor NFA activities through periodic rule enforcement reviews, and NFA remains subject to the present requirement that it monitor compliance with the conditions and restrictions imposed on conditioned and restricted registrants.

Sincerely,

Jean A. Webb,

Secretary of the Commission.

[11] Section 8c(a)(2) states, in relevant part, that ''[A]n exchange * * * shall not disclose the evidence therefor, except to the person who is suspended, expelled, disciplined, or denied access, and to the Commission.''

[12] Of course, the Commission could request records from the exchange and forward them to NFA. The Commission believes that this is an unnecessary administrative process and that NFA should obtain the records it needs to carry out the delegated function of conducting disciplinary history reviews directly from the exchanges. In this context and pursuant to Commission orders authorizing NFA to institute adverse registration actions, NFA should be viewed as standing in the shoes of the Commission.

22. Part 3 is amended by adding Appendix B to read as follows:

Appendix B to Part 3—Statement of Acceptable Practices with Respect to Ethics Training

(a) The provisions of section 4p(b) of the Act (7 U.S.C. 6p(b) (1994)) set forth requirements regarding training of registrants as to their responsibilities to the public. This section requires the Commission to issue regulations requiring new registrants to attend ethics training sessions within six months of registration, and all registrants to attend such training on a periodic basis. Consistent with the will of Congress, the Commission believes that a Core Principle for all persons intermediating transactions in recognized multilateral trade execution facilities is fitness. The awareness and maintenance of professional ethical standards are essential elements of a registrant's fitness. Further, the use of ethics training programs is relevant to a registrant's maintenance of adequate supervision, itself a Core Principle, and a requirement under Rule 166.3.

(b)(1) The Commission recognizes that technology has provided new, faster means of sharing and distributing information. In view of the foregoing, the Commission has chosen to allow registrants to develop their own ethics training programs. Nevertheless, futures industry professionals may want guidance as to the role of ethics training. Registrants may wish to consider what ethics training should be retained, its format, and how it might best be implemented. Therefore, the Commission finds it appropriate to issue this Statement of Acceptable Practices regarding appropriate training for registrants, as interpretative guidance for intermediaries on fitness and supervision. Commission registrants may look to this Statement of Acceptable Practices as a ''safe harbor'' concerning acceptable procedures in this area.

(2) The Commission believes that section 4p(b) of the Act reflects an intent by Congress that industry professionals be aware, and remain abreast, of their continuing obligations to the public under the Act and the regulations thereunder. The text of the Act provides guidance as to the nature of these responsibilities. As expressed in section 4p(b) of the Act, personnel in the industry have an obligation to the public to observe the Act, the rules of the Commission, the rules of any appropriate self-regulatory organizations or contract markets (which would also include recognized futures exchanges and recognized derivatives transactions facilities), or other applicable federal or state laws or regulations. Further, section 4p(b) acknowledges that registrants have an obligation to the public to observe ''just and equitable principles of trade.''

(3) Additionally, section 4p(b) reflects Congress' intent that registrants and their personnel retain an up-to-date knowledge of these requirements. The Act requires that registrants receive training on a periodic basis. Thus, it is the intent of Congress that Commission registrants remain current with regard to the ethical ramifications of new technology, commercial practices, regulations, or other changes.

(c) The Commission believes that training should be focused to some extent on a person's registration category, although there will obviously be certain principles and issues common to all registrants and certain general subjects that should be taught. Topics to be addressed include:

(1) An explanation of the applicable laws and regulations, and the rules of self-regulatory organizations or contract markets, recognized futures exchanges and derivatives transaction facilities;

(2) The registrant's obligation to the public to observe just and equitable principles of trade;

(3) How to act honestly and fairly and with due skill, care and diligence in the best interests of customers and the integrity of the market;

(4) How to establish effective supervisory systems and internal controls;

(5) Obtaining and assessing the financial situation and investment experience of customers;

(6) Disclosure of material information to customers; and

(7) Avoidance, proper disclosure and handling of conflicts of interest.

(d) An acceptable ethics training program would apply to all of a firm's associated persons and its principals to the extent they are required to register as associated persons. Additionally, personnel of firms that rely on their registration with other regulators, such as the Securities and Exchange Commission, should be provided with ethics training to the extent the Act and the Commission's regulations apply to their business.

(e) As to the providers of such training, the Commission believes that classes sponsored by independent persons, firms, or industry associations would be acceptable. It would also be permissible to conduct in-house training programs. Further, registrants should ascertain the credentials of any ethics training providers they retain. Thus, persons who provide ethics training should be required to provide proof of satisfactory completion of the proficiency testing requirements applicable to the registrant and evidence of three years of relevant industry or pedagogical experience in the field. This industry experience might include the practice of law in the fields of futures or securities, or employment as a trader or risk manager at a brokerage or end-user firm. Likewise, the Commission believes that registrants should employ as ethics training providers only those persons they reasonably believe in good faith are not subject to any investigations or to bars to registration or to service on a self-regulatory organization governing board or disciplinary panel.

(f)(1) With regard to the frequency and duration of ethics training, it is permissible for a firm to require training on whatever periodic basis and duration the registrant (and relevant self-regulatory organizations) deems appropriate. It may even be appropriate not to require any such specific requirements as, for example, where ethics training could be termed ongoing. For instance, a small entity, sole proprietorship, or even a small section in an otherwise large firm, might satisfy its obligation to remain current with regard to ethics obligations by distribution of periodicals, legal cases, or advisories. Use of the latest information technology, such as Internet websites, can be useful in this regard. In such a context, there would be no structured classes, but the goal should be a continuous awareness of changing industry standards. A corporate culture to maintain high ethical standards should be established on a continuing basis.

(2) On the other hand, larger firms which transact business with a larger segment of the public may wish to implement a training program that requires periodic classwork. In such a situation, the Commission believes it appropriate for registrants to maintain such records as evidence of attendance and of the materials used for training. In the case of a floor broker or floor trader, the applicable contract market, recognized futures exchange or derivatives transaction facility should maintain such evidence on behalf of its member. This evidence of ethics training could be offered to demonstrate fitness and overall compliance during audits by self-regulatory organizations, and during reviews of contract market, recognized futures exchange or derivatives transaction facility operations.

(g) The methodology of such training may also be flexible. Recent innovations in information technology have made possible new, fast, and cost-efficient ways for registrants to maintain their awareness of events and changes in the commodity interest markets. In this regard, the Commission recognizes that the needs of a firm will vary according to its size, personnel, and activities. No format of classes will be required. Rather, such training could be in the form of formal class lectures, video presentation, Internet transmission, or by simple distribution of written materials. These options should provide sufficiently flexible means for adherence to Congressional intent in this area.

(h) Finally, it should be noted that self-regulatory organizations and industry associations will have a significant role in this area. Such organizations may have separate ethics and proficiency standards, including ethics training and testing programs, for their own members.

PART 4—COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS

23. The authority citation for Part 4 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 4, 6b, 6c, 6l, 6m, 6n, 6o, 12a, and 23.

24. Section 4.10 is amended by revising paragraph (e)(1) to read as follows:

§ 4.10 Definitions.

* * * * *

(e)(1) *Principal,* when referring to a person that is a principal of a particular entity, shall have the same meaning as the term ''principal'' under § 3.1(a) of this chapter.

* * * * *

25. Section 4.24 is amended by revising paragraphs (f)(1)(v) and (h)(2) to read as follows:

§ 4.24 General disclosures required.

* * * * *

(f) * * *

(1) * * *

(v) Each principal of the persons referred to in this paragraph (b)(1) who participates in making trading or operational decisions for the pool or who supervises persons so engaged.

* * * * *

(h) * * *

(2) A description of the trading and investment programs and policies that will be followed by the offered pool, including the method chosen by the pool operator concerning how futures commission merchants carrying the pool's accounts shall treat offsetting positions pursuant to § 1.46 of this chapter, if the method is other than to close out all offsetting positions or to close out offsetting positions on other than a first-in, first-out basis, and any material restrictions or limitations on trading required by the pool's organizational documents or otherwise. This description must include, if applicable, an explanation of the systems used to select commodity trading advisors, investee pools and types of investment activity to which pool assets will be committed;

* * * * *

26. Section 4.32 is added to read as follows:

§ 4.32 Trading on a derivatives transaction facility for non-institutional customers.

(a) A registered commodity trading advisor may enter trades on or subject to the rules of a derivatives transaction facility on behalf of a client who does not qualify as an ''institutional customer'' as defined in § 1.3(g) of this chapter, provided that the trading advisor:

(1) Directs the client's commodity interest account;

(2) Directs accounts containing total assets of not less than $25,000,000 at the time the trade is entered; and

(3) Discloses to the client that the trading advisor may enter trades on or subject to the rules of a derivatives transaction facility on the client's behalf.

(b) The commodity interest account of a client described in paragraph (a) of this section must be carried by a registered futures commission merchant.

27. Section 4.34 is amended by revising paragraphs (f)(1)(ii) and (h) to read as follows:

§ 4.34 General disclosures required.

* * * * *

(f) * * *

(1) * * *

(ii) Each principal of the trading advisor who participates in making trading or operational decisions for the trading advisor or supervises persons so engaged.

* * * * *

(h) *Trading program.* A description of the trading program, which must include the method chosen by the commodity trading advisor concerning how futures commission merchants carrying accounts it manages shall treat offsetting positions pursuant to § 1.46 of this chapter, if the method is other than to close out all offsetting positions or to close out offsetting positions on other than a first-in, first-out basis, and the types of commodity interests and other interests the commodity trading advisor intends to trade, with a description of any restrictions or limitations on such trading established by the trading advisor or otherwise.

PART 140—ORGANIZATION, FUNCTIONS AND PROCEDURES OF THE COMMISSION

28. The authority citation for Part 140 continues to read as follows:

Authority: 7 U.S.C. 4a, 12a.

29. Section 140.91 is amended by adding a new paragraph (a)(7) to read as follows:

§ 140.91 Delegation of authority to the Director of the Division of Trading and Markets.

(a) * * *

(7) All functions reserved to the Commission in § 1.25 of this chapter.

* * * * *

PART 155—TRADING STANDARDS

30. The authority citation for Part 155 continues to read as follows:

Authority: 7 U.S.C. 6b, 6c, 6g, 6j and 12a unless otherwise noted.

§§ 155.2, 155.3, 155.4 and 155.5 [Amended]

31. Sections 155.2, 155.3, 155.4 and 155.5 are amended by adding the words ''or recognized futures exchange'' after the words ''contract market'' each time they appear.

32. Section 155.6 is added to read as follows:

§ 155.6 Trading standards for the transaction of business on derivatives transaction facilities.

(a) A futures commission merchant, or affiliated person thereof, transacting business on behalf of a customer who does not qualify as an ''institutional customer'' as defined in § 1.3(g) of this chapter on a derivatives transaction facility shall comply with the provisions of § 155.3.

(b) No futures commission merchant, introducing broker or affiliated person thereof shall misuse knowledge of any institutional customer's order for execution on a derivatives transaction facility.

PART 166—CUSTOMER PROTECTION RULES

33. The authority citation for Part 166 is amended to read as follows:

Authority: 7 U.S.C. 1a, 2, 4, 6b, 6c, 6d, 6g, 6h, 6k, 6l, 6o, 7a, 12a, 21 and 23, unless otherwise noted.

34. Section 166.5 is added to read as follows:

§ 166.5 Dispute settlement procedures.

(a) *Definitions.* (1) The term *claim or grievance* as used in this section shall mean any dispute that:

(i) Arises out of any transaction executed on or subject to the rules of a contract market, a recognized futures exchange or a derivatives transaction facility,

(ii) Is executed or effected through a member of such facility, a participant transacting on or through such facility or an employee of such facility, and

(iii) Does not require for adjudication the presence of essential witnesses or third parties over whom the facility does not have jurisdiction and who are not otherwise available.

(iv) The term claim or grievance does not include disputes arising from cash market transactions that are not a part of or directly connected with any transaction for the purchase or sale of any commodity for future delivery or commodity option.

(2) The term *customer* as used in this section includes an option customer (as defined in § 1.3(jj) of this chapter) and any person for or on behalf of whom a member of a contract market, a recognized futures exchange or a derivatives transaction facility or a participant transacting on or through such market, exchange or facility effects a transaction on or through such market, exchange or facility, except another member of or participant in such market, exchange or facility. *Provided, however,* a person who is an ''institutional customer'' as defined in § 1.3(g) of this chapter shall not be deemed to be a customer within the meaning of this section.

(3) The term *Commission registrant* as used in this section means a person registered under the Act as a futures commission merchant, introducing broker, floor broker, commodity pool operator, commodity trading advisor, or associated person.

(b) *Voluntariness.* The use by customers of dispute settlement procedures shall be voluntary as provided in paragraph (c) of this section.

(c) *Pre-dispute arbitration agreements.* No Commission registrant shall enter into any agreement or understanding with a customer in which the customer agrees, prior to the time a claim or grievance arises, to submit such claim or grievance to any settlement procedure except as follows:

(1) Signing the agreement must not be made a condition for the customer to utilize the services offered by the Commission registrant.

(2) If the agreement is contained as a clause or clauses of a broader agreement, the customer must separately endorse the clause or clauses containing the cautionary language and provisions specified in this section. A futures commission merchant or introducing broker may obtain such endorsement as provided in § 1.55(d) of this chapter for the following classes of customers only:

(i) A plan defined as a government plan or church plan in section 3(32) or section 3(33) of title I of the Employee Retirement Income Security Act of 1974, or a foreign person performing a similar role or function subject as such to comparable foreign regulation; and

(ii) A person who is a ''qualified eligible person'' as defined in § 4.7 of this chapter.

(3) The agreement may not require the customer to waive the right to seek reparations under section 14 of the Act and part 12 of this chapter. Accordingly, the customer must be advised in writing that he or she may seek reparations under section 14 of the Act by an election made within 45 days after the Commission registrant notifies the customer that arbitration will be demanded under the agreement. This notice must be given at the time when the Commission registrant notifies the customer of an intention to arbitrate. The customer must also be advised that if he or she seeks reparations under section 14 of the Act and the Commission declines to institute reparation proceedings, the claim or grievance will be subject to the pre-existing arbitration agreement and must also be advised that aspects of the claim or grievance that are not subject to the reparations procedure (*i.e.,* do not constitute a violation of the Act or rules thereunder) may be required to be submitted to the arbitration or other dispute settlement procedure set forth in the pre-existing arbitration agreement.

(4) The agreement must advise the customer that, at such time as he or she may notify the Commission registrant that he or she intends to submit a claim to arbitration, or at such time as such person notifies the customer of its intent to submit a claim to arbitration, the customer will have the opportunity to elect a qualified forum for conducting the proceeding.

(5) *Election of forum.* (i) Within ten business days after receipt of notice from the customer that he or she intends to submit a claim to arbitration, or at the time a Commission registrant notifies the customer of its intent to submit a claim to arbitration, the Commission registrant must provide the customer with a list of organizations whose procedures meet Acceptable Practices established by the Commission for customer dispute resolution, together with a copy of the rules of each forum listed. The list must include:

(A) The contract market, recognized futures exchange or derivatives transaction facility, if available, upon which the transaction giving rise to the dispute was executed or could have been executed;

(B) A registered futures association; and

(C) At least one other organization that will provide the customer with the opportunity to select the location of the arbitration proceeding from among several major cities in diverse geographic regions and that will provide the customer with the choice of a panel or other decision-maker composed of at least one or more persons, of which at least a majority are not members or associated with a member of the contract market, recognized futures exchange or derivatives transaction facility or employee thereof, and that are not otherwise associated with the contract market, recognized futures exchange or derivatives transaction facility (mixed panel): *Provided,* *however,* that the list of qualified organizations provided by a Commission registrant that is a floor broker need not include a registered futures association unless a registered futures association has been authorized to act as a decision-maker in such matters.

(ii) The customer shall, within forty-five days after receipt of such list, notify the opposing party of the organization selected. A customer's failure to provide such notice shall give the opposing party the right to select an organization from the list.

(6) *Fees.* The agreement must acknowledge that the Commission registrant will pay any incremental fees that may be assessed by a qualified forum for provision of a mixed panel, unless the arbitrators in a particular proceeding determine that the customer has acted in bad faith in initiating or conducting that proceeding.

(7) *Cautionary Language.* The agreement must include the following language printed in large boldface type:

Three Forums Exist for the Resolution of Commodity Disputes: Civil Court litigation, reparations at the Commodity Futures Trading Commission (CFTC) and arbitration conducted by a self-regulatory or other private organization.

The CFTC recognizes that the opportunity to settle disputes by arbitration may in some cases provide many benefits to customers, including the ability to obtain an expeditious and final resolution of disputes without incurring substantial costs. The CFTC requires, however, that each customer individually examine the relative merits of arbitration and that your consent to this arbitration agreement be voluntary.

By signing this agreement, you: (1) May be waiving your right to sue in a court of law; and (2) are agreeing to be bound by arbitration of any claims or counterclaims which you or [name] may submit to arbitration under this agreement. You are not, however, waiving your right to elect instead to petition the CFTC to institute reparations proceedings under Section 14 of the Commodity Exchange Act with respect to any dispute that may be arbitrated pursuant to this agreement. In the event a dispute arises, you will be notified if [name] intends to submit the dispute to arbitration. If you believe a violation of the Commodity Exchange Act is involved and if you prefer to request a section 14 ''Reparations'' proceeding before the CFTC, you will have 45 days from the date of such notice in which to make that election.

You need not sign this agreement to open or maintain an account with [name]. ***See*** **17 CFR 166.5.**

(d) *Enforceability.* A dispute settlement procedure may require parties utilizing such procedure to agree, under applicable state law, submission agreement or otherwise, to be bound by an award rendered in the procedure, provided that the agreement to submit the claim or grievance to the procedure was made in accordance with paragraph (c) of this section or that the agreement to submit the claim or grievance was made after the claim or grievance arose. Any award so rendered shall be enforceable in accordance with applicable law.

(e) *Time limits for submission of claims.* The dispute settlement procedure established by a contract market, recognized futures exchange or derivatives transaction facility shall not include any unreasonably short limitation period foreclosing submission of customers' claims or grievances or counterclaims.

(f) *Counterclaims.* A procedure established by a contract market, recognized futures exchange, or derivatives transaction facility under the Act for the settlement of customers' claims or grievances against a member or employee thereof may permit the submission of a counterclaim in the procedure by a person against whom a claim or grievance is brought. The contract market, recognized futures exchange, or derivatives transaction facility may permit such a counterclaim where the counterclaim arises out of the transaction or occurrence that is the subject of the customer's claim or grievance and does not require for adjudication the presence of essential witnesses, parties, or third persons over whom the contract market, recognized futures exchange, or derivatives transaction facility does not have jurisdiction. Other counterclaims arising out of a transaction subject to the Act and rules promulgated thereunder for which the customer utilizes the services of the registrant may be permissible where the customer and the registrant have agreed in advance to require that all such submissions be included in the proceeding, and if the aggregate monetary value of the counterclaim is capable of calculation.

(g) *Institutional customers.* (1) A person who is an ''institutional customer'' as defined in § 1.3(g) of this chapter may negotiate any term of an agreement or understanding with a Commission registrant in which the institutional customer agrees, prior to the time a claim or grievance arises, to submit such claim or grievance to any settlement procedure, except that signing the agreement must not be made a condition for the institutional customer to use the services offered by the registrant.

(2) If the agreement is contained as a clause or clauses of a broader agreement, the institutional customer must separately endorse the clause or clauses containing the agreement; *Provided, however,* a futures commission merchant or introducing broker may obtain such endorsement as provided in § 1.55(d) of this chapter.

Issued in Washington, D.C. on November 21, 2000 by the Commission.

Jean A. Webb,

Secretary of the Commission.

[FR Doc. 00–30268 Filed 12–12–00; 8:45 am]

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COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 39

RIN 3038–AB57

A New Regulatory Framework for Clearing Organizations

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rulemaking.

SUMMARY: The Commodity Futures Trading Commission (Commission or CFTC) is promulgating a new regulatory framework to apply to clearing organizations. These regulations for clearing organizations are part of an initiative that would also establish a new regulatory framework for multilateral transaction execution facilities (MTEF) and market intermediaries. The final new framework in its entirety is simultaneously announced today in companion releases. The new framework, including these regulations are centered on broad, flexible, core principles and are designed to ''promote innovation, maintain U.S. competitiveness, and at the same time reduce systemic risk and protect customers.'' The Commission has fashioned these regulations so that it can fairly and efficiently carry out the important duty of overseeing clearing organizations in a changing, dynamic industry pursuant to a transparent codified framework.

EFFECTIVE DATE: February 12, 2001.

FOR FURTHER INFORMATION CONTACT: Alan L. Seifert, Deputy Director, Division of Trading and Markets, or Lois J. Gregory, Special Counsel, Division of Trading and Markets, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581. Telephone (202) 418–5260 or e-mail *PArchitzel@cftc.gov, ASeifert@cftc.gov,* or *LGregory@cftc.gov.*

SUPPLEMENTARY INFORMATION: