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

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

IV. Comments Received

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

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

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

and regulatory provisions.

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

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

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

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

Finally, certain government regulators commenting on the proposed rules, although generally urging caution, recognized that a pilot program was an appropriate framework for proceeding. In particular, the Board of Governors of the Federal Reserve System ("Federal Reserve Board" or "Board") noted that it supported the Commission's use of its authority to grant exemptions to classes of products and market participants for which many of the Act's requirements are unnecessary or burdensome. The Board further stated, however, that exemptions of the breadth contemplated

by the exchange petitions could have unintended effects on market integrity, and urged the Commission to take a cautious approach in applying its exemptive authority to exchange-traded instruments.

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

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

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