will permit hedge funds, ²⁶ which although subject to the ICA are generally excluded from regulation under it, to qualify as eligible participants. The \$5 million asset floor, however, which applies to commodity pools under both Part 36 and Part 35, ²⁷ is being adopted under section 36.1(c)(2)(iv). ²⁸ In all other respects the substance of section 36.1(c)(2)(iv), as adopted, conforms to its counterpart under Part 35.

The provisions of proposed section 36.1(c)(2)(vi), which would apply to a corporation, partnership, organization, trust, or other entity, would have required that such an entity not be formed solely for the purpose of constituting an eligible participant, and have either (1) assets exceeding \$10 million, or (2) a net worth of \$1 million and that the transaction be entered into in connection with the conduct of the entity's business or to manage the risk of an asset or liability owned or incurred in the conduct of the entity's business or reasonably likely to be owned or incurred in the conduct of its business. The proposed Part 36 rule differed from the Part 35 provision in two respects. First, proposed section 36.1(c)(2)(vi) did not include a provision similar to that of section 35.1(b)(2)(vi), which permits the entity to be an eligible swap participant by obtaining a guarantee of the obligation of the party under the swap agreement in lieu of meeting the \$10 million asset test. However, because all section 4(c) contract market transactions will be guaranteed by a clearing organization, the ability to obtain a guarantee is not a measure of counterparty creditworthiness, and hence the alternative guarantee test of swap eligibility is inapplicable to section 4(c) contract market transactions. Accordingly, the final Part 36 rule continues, as proposed, to differ in this respect from Part 35.29

eligible participant and has total assets exceeding \$5 million are already consistent with Part 35, and are being adopted as proposed.

The second difference between the proposed Part 36 rule and its Part 35 counterpart was a clarification in section 36.1(c)(2)(vi) that commodity pools, investment companies or hedge funds qualify for exemptive relief under the specific eligibility provision applicable to them, and not under the more general provision of subsection (vi). The Commission's inclusion of the phrase "other than a commodity pool or other collective investment vehicle" in proposed subsection (vi) was a technical clarification, and was not intended as a substantive change to the exemptive framework.

However, in order to maintain consistency between the language of Parts 36 and 35 to the greatest degree possible, the Commission is not including this additional, clarifying language in section 36.1(c)(2)(vi). Nevertheless, the Commission intends that to be deemed an eligible participant in a section 4(c) contract market transaction, an investment company or a hedge fund must qualify under section 36.1(c)(2)(iv), and a commodity pool must qualify under section 36.1(c)(2)(v). The Commission interprets Part 35 similarly, so that to qualify as an eligible swap participant, an investment company or hedge fund must meet the standards of section 35.1(b)(2)(iv), and a commodity pool must meet the standards of section 35.1(b)(2)(v). These specific provisions are the only avenues through which a commodity pool, investment company or hedge fund can qualify as an eligible participant for section 4(c) contract market transactions under Part 36, or as an eligible swap participant under Part 35.30

B. Conditions on Transactions Which Are Included Under Part 36

As summarized above, transactions included within the proposed Part 36 exemption were required to meet a

Such requirements were not imposed based on the Commission's understanding that any floor broker or floor trader would, by necessity, be a member in good standing of the 4(c) contact market whose transactions thereon would be guaranteed by an exchange clearing member. The Commission's understanding in this regard was confirmed by one exchange. A second exchange expressed its view that exchange rules adequately address such financial matters. Accordingly, at this time, the Commission sees no need to impose explicit clearing member guarantee or financial requirements on floor brokers and floor traders.

number of additional conditions. Specifically, proposed section 36.2 required that section 4(c) contract market transactions provide for cash settlement, be cleared through a clearing organization, not involve domestic agricultural commodities, not involve a previously designated futures or option contract, and not involve futures or option contracts subject to the provisions of section 2(a)(1)(B) of the Act. The comments submitted on each of these conditions are discussed below.

1. Cash Settlement

The Coffee, Sugar & Cocoa Exchange, Inc. ("CSCE") objected to the requirement as proposed in section 36.2(a)(1) that the settlement or delivery of section 4(c) contract market transactions be in cash or by means other than transfer or receipt of a commodity. The CSCE opined that requiring cash settlement would limit section 4(c) contract market transactions to economically inferior contracts in those instances where a physical delivery contract may be superior to a cash settled contract. The CSCE further reasoned that because access to section 4(c) contract markets is limited to sophisticated traders, who presumably have greater familiarity with the procedures for making or taking physical delivery, there is less reason to restrict the availability of physical delivery contracts under the exemption.31

The Commission disagrees with this view. To the contrary, the Commission notes that, in its experience, most surveillance problems have arisen in the context of market congestion relating to the delivery of physical commodities. Generally, in order to minimize the possibility of market congestion or manipulation, the Commission evaluates the adequacy of deliverable supplies and delivery procedures during its review of contract market

²⁶The term "hedge fund" is now commonly used to refer to a wide array of private collective investment vehicles, usually organized as limited partnerships and organized so as to avoid the application of most securities laws.

²⁷ See, 17 CFR 35.1(b)(2)(v) (1995).

²⁸ The \$5 million asset floor being adopted under Section 36.1(c)(2)(iv) will apply to hedge funds even though there is no comparable requirement for eligibility under Part 35. The Commission believes, however, that this slight difference in the definitions will not disadvantage any hedge funds seeking to participate in Section 4(c) contract market transactions and provides for consistent treatment under Part 36 for commodity pools and hedge funds with respect to the imposition of an asset floor.

²⁹ The proposed rules also differed from Part 35 to the extent they did not impose specific financial requirements on floor brokers and floor traders.

³⁰ Section 36.1(c)(2)(vi) cannot be used to abrogate the limits on commodity pool or other collective investment vehicle eligibility. Section 36.1(c)(2)(vi) (B) and (C) only apply to an entity engaged in risk management or commercial conduct that has a principal business other than serving as a passive investment vehicle and is not intended to be available to passive investment vehicles like commodity pools, investment companies or hedge funds. See also, Section 35.1(b)(2)(vi)(C).

³¹ A commenter stated that a physical delivery commodity futures contract, in fact, may require that certain documents, rather than the actual commodity itself, be transferred at the time of delivery. The commenter noted that these documents create a subsequent contractual agreement to deliver the physical commodity and therefore such contracts should be eligible to trade as Section 4(c) transactions. The Commission disagrees. Most "physical delivery" contracts provide for the transfer of documents (e.g., warehouse receipts, shipping certificates, vault receipts, etc.) as part of the delivery process However, the ultimate satisfaction of such contracts is by physical delivery of the commodity pursuant to exchange-specified rules. Thus, the fact that documents are transferred as a means of executing the delivery process does not qualify such contracts for Section 4(c) transactions, because settlement ultimately would not be in cash or means other than transfer or receipt of a commodity, as required by Rule 36.2(a)(1).