applications for designation. Section 4(c) contracts, however, will not be required to undergo such a review process. Accordingly, the Commission believes that restricting eligible section 4(c) contract market transactions to those that do not involve physical delivery of a commodity is a prudent measure to mitigate concerns regarding the delivery process and deliverable supplies. That is not to say, however, that after gaining experience with the trading of section 4(c) contract market transactions during the pilot program, the Commission will not revisit this issue for all, or certain classes of, commodities.

The proposed limitation on the physical delivery of commodities on section 4(c) contract market transactions did contain an exception for the physical delivery of a "major foreign currency." The CME suggested that the restriction of this exception to "major" foreign currencies should be removed from the final regulations. It reasoned that the need for risk management by participants in markets for many of the 'non-major' currencies is as great, if not greater, than in the major currency markets. In its view, the rule, at a minimum, should be revised to clarify the meaning of "major currency," a term otherwise undefined in the proposed rules. The CME suggested that "major" currencies include all currencies for which there are no legal impediments to delivery or cash settlement and in which a sufficiently liquid spot market exists.

The Commission disagrees with the commenter that physical delivery should be permitted on a section 4(c) contract market for any foreign currency, no matter how thin its cash market. To the contrary, the cash market for a foreign currency must be sufficiently liquid and unimpeded by legal restraints to permit its ready delivery. Otherwise, the contract would be susceptible to manipulation, price distortion or default. Indeed, it was based upon this reasoning that the Commission initially proposed to limit the exception to physical delivery of 'major foreign currencies."

However, the Commission agrees that the proposed rule's use of the undefined term "major currency" needs clarification. The final rule, therefore, substitutes the descriptive criteria suggested by the commenter for the term 'major currency.'' That is, physical delivery is permitted in section 4(c) contract market transactions for foreign currencies which have no legal impediment to such a delivery and for which there exists a sufficiently liquid cash market.

2. Clearing and Related Financial **Integrity Issues**

a. Clearing

Because the exemption deems all section 4(c) contract markets to be designated as contract markets, the Commission also proposed to require that section 4(c) contract markets maintain a clearing facility subject to Commission oversight, and that the rules of the clearing organization be submitted to the Commission for approval pursuant to section 5a(a)(12)(A) of the Act.32 The Philadelphia Stock Exchange ("PHLX"), commented that the Commission should apply this requirement "flexibly." According to the PHLX, the Commission should permit, for example, transactions cleared by a registered securities clearing agency pursuant to a comparable regulatory scheme.

As the Commission noted in its Notice of Proposed Rulemaking, in proposing these rules it did not intend:

to limit contract markets in section 4(c) contract market transactions to current contract markets or exchanges. In order to qualify, such an entity would be treated similarly to a board of trade seeking an initial designation as a contract market.

59 FR at 54144. Nevertheless, the Commission believes that all section 4(c) contract markets should be subject to direct Commission oversight and enforcement of all of the self-regulator's rules, particularly those regarding the financial integrity of the transactions. Accordingly, although a clearing agency registered under a comparable regulatory scheme such as that administered by the SEC would be eligible to clear section 4(c) contract market transactions under Part 36, the entity would, nonetheless, also be required to qualify as a clearing organization under the CEA and Commission rules, clear for a board of trade which has been designated as a section 4(c) contract market, and submit its rules for approval to the Commission pursuant to section 5a(a)(12)(A) of the Act.

In addition to those questions relating to the clearing of section 4(c) contract market transactions,33 several

commenters raised a variety of issues relating to the financial integrity requirements applicable to all designated contract markets. Under the proposed pilot program, these financial integrity requirements would be applied to section 4(c) contract markets. Commenters noted that the Commission did not propose, in the context of this section 4(c) exemption, any modifications to these requirements and requested various forms of relief.

b. Segregation of Customer Funds

For example, the CME, both in its petition and in its comments on proposed Part 36, asserted that the requirement of Commission Rule 1.20 to segregate all customer funds is not necessary to "the smooth and safe functioning of the Rolling Spot Futures Contracts." 34 However, segregation of customer funds is a cornerstone of the Commission's customer protection and financial integrity framework. In light of its importance to safeguarding customer funds, the Commission is not prepared to grant relief from the segregation requirement.

The CBT requested that the Commission grant an exemption for section 4(c) contract market transactions from Commission Rule 1.25, which the CBT describes as a rule prohibiting an FCM from investing customer funds in anything other than U.S. government securities.35 The CBT views the permissible investments under Rule 1.25 as unduly restrictive and stated that there are other liquid investments, such as corporate investment grade bonds, that would be safe, appropriate investments of customer funds. The CBT stated that exchanges should be allowed to determine how customer funds deposited with an FCM in connection with trading on these exempt markets can be invested.36

³² The term "contract market" includes a clearing organization that clears trades for the contract market. Commission Rule 1.41(a)(3)

³³ The CME suggested that the Commission permit the clearing of Part 36 transactions on a faster schedule or otherwise in a more innovative fashion than that provided for traditional designated contract markets. This issue is discussed below, as it relates to trading rules. As a general matter, however, the Commission believes that, for all markets, whether traditional or exempt under Part 36, an expeditious clearing system, by reducing the time during which transactions are unsettled

and the parties at risk, is crucial to minimizing systemic risks. Accordingly, although Section 4(c) transactions generally may be part of the same clearing regimen as non-exempt transactions, nothing in the Part 36 rules would prohibit faster or more innovative clearance of these instruments.

^{34 58} FR 43424-25

³⁵ In fact, Rule 1.25 also permits customer funds to be invested in certain municipal securities, subject to staff interpretations that such investments must be liquid. Rule 1.25 provides in pertinent part that "[n]o [FCM] and no clearing organization shall invest customer funds except in obligations of the United States, in general obligations of any State or any political subdivision thereof, or in obligations fully guaranteed as to principal and interest by the United States." See also CFTC Interpretative Letter No. 86–21, [1986–1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶23,266 (Sept. 17, 1986)

³⁶ As an alternative to exemption from Rule 1.25, the CBT suggested that the Commission specify an expanded range of permissible investments of customer funds. If this approach were adopted, the