option contracts will apply in the same manner to section 4(c) contract market transactions.<sup>41</sup>

## 3. Excluded Commodities

The scope of the section 4(c)exemption was proposed to be further limited by its inapplicability to transactions in certain, identified commodities and by the general restriction that a section 4(c) contract market transaction could not be offered for a contract previously designated as a traditional contract market. Two commenters objected to section 36.2(a)(3)'s proposed prohibition of section 4(c) contract market transactions on specified domestic agricultural commodities.42 The CME and the CSCE noted that the Commission did not propose to prohibit section 4(c) trading in many other physical commodities already trading as non-exempt futures and options, such as sugar, coffee, copper, crude oil, lumber, and scrap metal. Any distinction between these two classes of physical commodities, according to the commenters, would be artificial.

The Commission disagrees. The commodities excluded from eligibility under proposed section 36.2(a)(3) are those agricultural commodities specifically enumerated in section 1a of the Act. The Commission is of the opinion that these commodities share certain characteristics relating to their underlying cash markets and the seasonality of their production, which make different treatment appropriate. As the Commission noted in the Notice of Proposed Rulemaking, the enumerated agricultural commodities are treated differently, as a class, in other contexts, as well. For example, the Commission directly administers speculative position limits under Part

<sup>42</sup> The rule, however, does allow for Section 4(c) transactions on a broad index of these enumerated commodities.

150 of its rules only for these commodities. In light of the apparent ability of the currently designated contract markets in these commodities to fulfill the price basing and hedging needs of market users and the untested operation of the Part 36 rules, the Commission believes that caution requires that these commodities be excluded from the pilot program. The Commission will reconsider this determination when it evaluates the success of the pilot program.

The Commission also proposed to exclude any transaction subject to section 2(a)(1)(B) of the Act, 7 U.S.C. 2, including stock index futures contracts, from the scope of the exemptive rules.<sup>43</sup> In contrast to the SEC, which specifically concurred with this part of the proposal, PHLX commented that:

nothing in the section 2(a)(1)(B) limitation on section 4(c) [prevents] the Commission from permitting a securities exchange that obtains a designation tailored to its special circumstances or a contract market affiliate of a securities exchange to trade stock index futures contracts or analogous products meeting the special criteria for futures contracts on groups or indexes of securities in a securities-style environment pursuant to the requirements of the 1934 Act, as long as the SEC has an opportunity to express its views on such contracts in accordance with the provisions of section 2(a)(1)(B).

Accordingly, PHLX asserted that the proposed exclusion of section 2(a)(1)(B) commodities was overly broad and should be narrowed or deleted in the final rules and that these issues be addressed in the context of individualized requests for exemptive relief.

Section 2(a)(1)(B) commodities raise particular issues in light of the nature of the underlying cash market and the special procedures that apply to designation of these commodities. Accordingly, the Commission continues to believe that inclusion of these commodities in a pilot program is inappropriate and has determined not to further revise section 36.2(a)(5) at this time. The Commission may reconsider the issue in the future, depending upon its regulatory experience.

More generally, the Commission proposed to limit section 4(c) contract market transactions to transactions which do

not involve any commodity futures contract or commodity option for which any board of trade has been designated by the Commission \* \* \* prior to its application to trade as a section 4(c) market transaction, unless it can reasonably be distinguished \* \* \* based on its hedging function and/or pricing basis.  $^{\rm 44}$ 

The Commission explained that it will base determinations as to whether proposed section 4(c) contract market transactions can be "reasonably distinguished" from existing contracts on the same considerations that it now applies in deciding whether proposed futures and options contracts are treated as separate designation applications, and provided several examples of instruments that are "reasonably distinguishable" from existing contracts. 59 FR 54145.45 Nevertheless, several commenters complained that the Commission's inclusion of examples of acceptable section 4(c) contract market transactions is not adequate to prevent misapplication or misinterpretation of the rule's terms. They suggested that the rule be amended to set forth a brighter line delineating those transactions which could be traded under Part 36.

The Commission believes that further enumeration of specific standards or commodity characteristics defining the universe of permissible section 4(c)contract market transactions would unnecessarily restrict the exchanges' and the Commission's flexibility for innovation under the proposed rules. Because the universe of eligible section 4(c) contract market transactions is so broad—including a wide range of diverse tangible commodities, financial instruments and indexes-a comprehensive listing of eligibility standards likely would be incomplete, failing to address questions regarding novel section 4(c) contract market transactions that may be designed in the future. Moreover, a detailed listing of eligibility requirements could have the unintended effect of excluding certain types or classes of contracts or commodities from the exemption. For these reasons, the Commission believes that a broad standard based on two fundamental economic characteristics of futures contracts-their hedging function or the basis on which they are priced-will provide maximum flexibility to the exchanges in

<sup>&</sup>lt;sup>41</sup> For example, the same distinctions between customer and proprietary transactions will apply for segregation and adjusted net capital purposes. so that the amount of customer funds related to Section 4(c) transactions will be included in the calculation of an FCM's minimum adjusted net capital requirement. Proprietary positions in such transactions will be subject to the same haircuts as proprietary positions in traditional contracts when an FCM computes its adjusted net capital. To the extent that Section 4(c) contract market transactions result in more long-dated transactions or in transactions with features, such as embedded options, which are substantially different from customary futures contracts, the Commission will reassess the continued efficacy of its capital requirements and make appropriate adjustments. Separately, the Commission may consider whether adjustments are appropriate in light of responses to the SEC's concept release on capital. 58 FR 27486 (May 10, 1993). In addition, the Commission recently held a roundtable on capital issues, generally.

 $<sup>^{43}</sup>$  See Proposed Section 36.2(a)(5). See also 59 FR at 54145.

<sup>&</sup>lt;sup>44</sup> Proposed Section 36.2(a)(4) is intended to address, among other things, the concerns expressed by some commenters regarding the problems of a two-tier marketplace. Although the CME and CBT have indicated that they do not intend to trade the same contract on both a Section 4(c) contract market and a traditional contract market, this provision would prevent a Section 4(c) contract market transaction from trading if the same traditional contract were already trading on a contract market.

<sup>&</sup>lt;sup>45</sup> In that regard, however, Section 36.2(a)(4) specifically states that five- and ten-year interest swap futures and option contracts, rolling spot and currency forward futures and option contracts and flexible options may be listed as Section 4(c) transactions.