developing new section 4(c) contract market transactions, while maintaining the goal of the rule to avoid two-tiered, identical markets trading under two differing regulatory regimes.⁴⁶

On a related issue, the CME suggested that even if the Commission concludes that the proposed standard separating exempt and non-exempt markets were appropriate, the mere existence of a similar, previous contract market designation is an overly-broad criterion. The comment suggested that the prohibition should apply only to contracts that have open interest at the time a Part 36 market proposes to list the section 4(c) transaction; otherwise, competing exchanges could stymie innovation by obtaining traditional contract market designations for markets which are never listed for trading.

The Commission agrees that this comment has merit. The Commission intends that the above provision only limit the trading of two-tiered markets, and does not intend for it to be a means of forestalling competition. Accordingly, the Commission is modifying the restriction, limiting the availability of the Part 36 exception only to contracts that are trading at the time a board of trade proposes to list for trading a section 4(c) contract market, rather than to all designated contract markets. Traded contracts are those in which any transactions occurred during the six complete consecutive calendar months preceding the date of application to trade a section 4(c) contract market.⁴⁷

4. Speculative Position Limits

Finally, an exchange commenter opined that the Commission should exempt section 4(c) contract markets from the requirement under Rule 1.61 that they set and administer speculative position limits. The commenter reasoned that enforcing speculative limits would serve little purpose in light of the requirement that all section 4(c) contract markets (except for foreign currencies) be cash-settled.

As the Commission articulated in the Notice of Proposed Rulemaking, Commission Rule 1.61 already is applied quite flexibly, permitting the exchanges to substitute various position accountability rules for speculative position limits for many futures and option contracts. However, commenters have argued forcefully that OTC markets and foreign exchanges enjoy a competitive advantage by generally not providing for any type of position accountability or position limit rules. The Commission, nevertheless, continues to believe that these types of rules provide the exchanges with a useful and flexible tool for addressing market surveillance concerns.

In any event, based upon the continuing perception of some industry sources that the existence of these rules on U.S. futures exchanges is an actual source of competitive disadvantage, the Commission, by adding a new subsection (b) to section 36.2, is exempting section 4(c) contract markets from the requirements of Rule 1.61. However, the decision of an exchange to discard this particular device from its surveillance tool chest does not, in any way, diminish the exchange's responsibilities under the Act to assure orderly markets. Accordingly, exchanges remain free, as a matter of exchange discretion, to apply position accountability or speculative position limit rules to section 4(c) contract markets.

C. Trading Rules and Procedures

1. The Proposed Rule

Proposed section 36.3 would have permitted a board of trade to submit for Commission approval flexible trading procedures for section 4(c) contract market transactions which were not required to comply in all respects with existing competitive trading requirements and other trading standards relative to the exposure of orders and trades. The proposal represented a substantial change in the principles underlying the required method of trading futures and futures option contracts in that it would have allowed the execution of section 4(c)

contract market transactions without exposing such transactions to competition in the pit. The proposal would have permitted exchanges, under a pilot program that would provide some relaxation in competitive trading requirements for certain market participants, to develop new trading procedures designed to address the needs of their increasingly institutional market participants and to compete more aggressively with the OTC market. The proposal also would have required exchange compliance with certain regulatory safeguards in order to maintain essential market and appropriate customer protection.

After reviewing the comments to proposed section 36.3 and customer protection rules in other markets, the Commission has determined to adopt section 36.3, modifying it from the proposal to address certain comments. As adopted, section 36.3 provides a framework of safeguards intended to set forth non-exclusive conditions for the execution of section 4(c) contract market transactions. Section 36.3 would permit expeditious review of exchange rules without prejudicing the ability of the exchanges to request Commission approval of other procedures pursuant to the usual rule approval procedures under section 5a(a)(12)(A) of the Act and Commission Rule 1.41(b). Effectively, the Commission is establishing a framework of safeguards for transparent, negotiated off-floor/expit trading. Experience with the permitted procedures may be required to determine whether other or different limitations are necessary or whether the type of activity that should be deemed to be in violation of the applicable antifraud rule should be further specified. Therefore, the Commission intends to evaluate its experience with contract market rules adopted under section 36.3 twelve months after such rules become effective and to propose, if necessary, modifications or limitations to the parameters for section 4(c) trading rules set forth herein to address any market problems which it observes.

Paragraph (a) of proposed section 36.3 provided that a board of trade could submit for Commission approval section 4(c) contract market trading rules to permit trading procedures for section 4(c) contract market transactions that do not satisfy all of the requirements of Commission Rules 1.38(a), 1.39, 155.2, 155.3 and 155.4. Paragraph (b)(3) of the proposed regulation, however, required compliance with Commission Rules 155.2, 155.3 and 155.4 to the extent applicable.

⁴⁶One commenter specifically requested that the Commission clarify whether a contract based on cash-settled North Sea crude oil or a contract based on cash-settled West Texas Intermediate (WTI) crude oil would be considered "reasonably distinguished" from the existing light sweet crude oil futures contract which provides for physical delivery of, and for which the pricing basis represents, WTI. Regarding the former, North Sea crudes are distinct from WTI, having different (albeit related) pricing characteristics, so that a WTI-based crude oil contract may not meet the hedging needs of firms having positions in North Sea crudes. Accordingly, Section 4(c) transactions would be permitted for cash-settled North Sea crude oil, since the hedging and pricing functions of these transactions would be distinguished from the existing designated WTI-based crude oil contract. In contrast, a cash-settled WTI crude oil contract would not be permissible, since there should be no material difference in the pricing basis of the contracts (both would reflect the value of WTI crude oil at Cushing, OK) and the hedging uses provided by each contract would be identical

⁴⁷The six-month period is consistent with the time period specified in Commission Rule 5.2 for classifying designated contract markets as "dormant," after which Commission approval is required to reactivate trading. However, the Commission is not including as a condition for Section 4(c) eligibility, Rule 5.2's five-year grace period, which commences at designation, during which a designated market is exempt from being considered "dormant."