2. Specific Exemptive Relief

Two commenters requested that the Commission provide increased specificity with regard to the kinds of transactions that could be executed using section 4(c) contract market trading procedures. Specifically, the FIA stated that it would be helpful "if the Commission would further set out the kinds of core trading practices it believes would be acceptable in the exempt exchange markets." The CBT stated that the "proposal would be greatly improved if the agency could provide some concrete idea of the kinds of procedures that would be acceptable under the exemption." The CBT further recommended that the Commission make explicit in its exemptive relief whether trading opposite customer orders and matching trades between customers or between customers and FCMs would be permitted.

The Commission believes that these comments have merit and has modified the trading rules requirements to provide explicit relief in the form of a safe harbor from the requirements of sections 4b(a)(iv), 4b(b) and 4c(a) of the Act, 7 U.S.C. 6b(a)(iv), 6b(b), and 6c(a), and Commission Rules 1.38(a), 1.39, 155.2, 155.3 and 155.4 for section 4(c) contract market transactions executed using "special execution procedures" in accordance with exchange rules that meet certain standards and are permitted to become effective by the Commission. For section 4(c) contract market transactions, such special execution procedures could permit noncompetitive bids, offers, negotiation and/or execution of such orders and transactions.

Subject to the requirement that they satisfy certain specified Commission recordkeeping and audit trail requirements, the Commission would allow exchange rules providing special execution procedures to become effective. These special procedures would permit a member to trade for his own account opposite the account of another member,48 permit an FCM or floor broker to take the opposite side of a customer order for its own account, or permit the execution of customer orders of different principals directly between customer accounts.49 The Commission also would allow to become effective exchange rules that permitted the execution of section 4(c) contract market transactions using any combination of special execution procedures and competitive on-floor trading procedures

provided that certain additional requirements were satisfied.⁵⁰

Exchanges also may submit for Commission review and approval, pursuant to the usual rule approval procedures contained in section 5a(a)(12)(A) of the Act, and Commission Rule 1.41(b), other section 4(c) contract market rules which do not conform to the specific trading standards set forth in section 36.3 and which do not satisfy the requirements of the Act and Commission regulations with regard to competitive trading requirements and other trading standards relative to the exposure of orders and trades.

In this regard, the Commission has provided greater specificity to give further content to the type of flexibility it intends to provide the exchanges to adapt trading procedures to new products, technology and market circumstances without sacrificing important customer and market protections. For example, it is the Commission's belief that boards of trade designated as section 4(c) contract markets could have market makers with affirmative obligations, specialist systems, "all or nothing" large-trader execution procedures and other trading procedures currently not necessarily consistent with Rules 1.38 and 1.39. The Commission would, however, expect the exchanges to have procedures to protect the integrity of pricing and to monitor compliance with the conditions and limitations of the relief as set forth herein, consistent with the affirmative obligations of exchanges to enforce compliance with existing exchange and Commission rules.

a. Recordkeeping and Audit Trail Requirements

As previously stated, all transactions executed using special execution procedures must satisfy certain recordkeeping and audit trail requirements. Paragraph (e)(1) of section 36.3 requires that the contract market provide for record maintenance and retention consistent with Commission Rule 1.31. The audit trail for all transactions executed using special execution procedures must meet the books and records, trade register, trade timing, and contract market oversight requirements of Rules 1.35(a), (e), (g) and (i), respectively.⁵¹ In addition, the

recordkeeping requirements set forth in Commission Rule 1.38(b), which requires the special identification of such transactions, must be satisfied for all transactions executed using special execution procedures. This is intended to permit identification of such transactions as different from regular contract market transactions for price discovery purposes.

b. Customer Orders and Disclosure Requirements

Customer orders that could be executed using special execution procedures, *i.e.*, where the FCM or floor broker takes the opposite side of a customer order for its own account or executes orders directly between customer accounts of different principals, would be required to satisfy certain recordkeeping and disclosure requirements in lieu of those now set forth in Commission Rules 1.39, 155.2, 155.3 and 155.4, but in addition to those required where members trade opposite each other.

The exchanges' rules must prohibit the FCM or floor broker from disclosing customer order information for purposes other than to facilitate the execution of that order. The exchanges' rules also must require that an FCM or floor broker provide certain disclosure to affected customers. Before the FCM or floor broker executes the first transaction using special execution procedures for a particular customer, he must provide the customer with a description of such procedures and, in particular, describe how such procedures differ from competitive on-floor trading procedures. The Commission believes that the FCM or floor broker should be required to make such disclosure to the customer only once, prior to the first transaction executed under such procedure for that customer, and that the disclosure should focus primarily on the differences relative to the method of determining the price at which the transaction is to be executed. Thus, although permitting certain practices which currently are prohibited in the exchange environment, these rules nevertheless will provide a greater degree of regulatory protection than is the case for similar OTC transactions.

FCMs and floor brokers executing customer orders also would be required to satisfy certain audit trail and recordkeeping requirements in that the FCM or floor broker must create and maintain a written record, such as an office order ticket, reflecting each customer order. The record must

⁴⁸ Section 36.3(b).

⁴⁹ Section 36.3(c).

⁵⁰ Section 36.3(d). Any section 4(c) contract market transactions executed competitively on-floor must comply with applicable Commission regulations and exchange rules that currently govern competitive on-floor trading.

⁵¹ In order to meet the trade timing requirement for transactions executed using special execution procedures, the contract market rule must specify that the actual time of execution must be recorded

and reported to the exchange immediately following the execution.