Commission regulations and exchange rules that currently govern competitive on-floor trading. Finally, an exchange rule that permits transactions to be executed using such a combination of procedures must include a specific prohibition against frontrunning between the on- and off-floor markets.⁵⁸

Morgan Stanley, among others, commented that the Commission should clarify the extent to which its relaxation of trading restrictions and, in particular, the relaxation of restrictions on off-floor discussions permitted under proposed section 36.3 is applicable to the execution of positions in non-exempt futures or option contracts which are related to section 4(c) contract market transactions. For example, although, under proposed Rule 36.2(a)(4), an exchange would not be able to trade identical section 4(c) and non-exempt futures or option contracts, traders may seek to trade on spread relationships between exempt and non-exempt 4(c) contracts.

The commenter suggested that the trading rules governing section 4(c) contract market transactions should be applicable in instances where a trading strategy involves both exempt and nonexempt transactions. The Commission disagrees. Where a trading strategy involves transactions executed under both special execution procedures and on-floor competitive procedures, the trader may not rely on its safe harbor for special execution trading procedures to govern both,59 although other exchange rules which address this situation could be submitted for Commission consideration.

3. Price Transparency

As the Commission stated in proposing section 36.3, transactions under this provision must be transparent.60 In that regard, paragraph (e)(2) of section 36.3 requires the immediate post-execution report of each purchase and sale transaction executed using special execution procedures by the member specified by exchange rule and the dissemination thereof. The required information includes, at a minimum, price, quantity and contract. The Commission believes that the dissemination of this information is critical for price basing purposes and, therefore, has noted in paragraph (e)(2) of the regulation that special execution transactions may be executed only during hours in which such immediate post-execution dissemination of price basing information is available.61 The Commission believes that the exchanges should determine how best to structure their proposals so as to assure the integrity of the prices set pursuant to special execution procedures. The Commission wishes to provide the exchanges significant flexibility to address this issue. In addition to other appropriate steps, an exchange could establish a minimum transaction size or could combine special execution procedures and on-floor procedures. The Commission also believes that to fulfill their other self-regulatory obligations, exchanges will have to define monitoring or other surveillance procedures to ensure compliance with these transaction reporting requirements.

4. Clearing

Paragraph (b)(5) of proposed section 36.3 would require that transactions be reported to clearing, and be cleared, on the same schedule as trades subject to Commission Rules 1.38 and 1.39 or otherwise be immediately reported to clearing. The CME commented that the proposal, taken literally, "would prohibit an exchange from using a Part 36 product as a testing ground to develop faster and more accurate procedures for clearing transactions." The Commission believes that this comment has merit and, in paragraph (e)(3) of this regulation, requires the report to clearing, and clearing, of each special execution transaction as quickly as practicable, but in no event later than that required for trades subject to Commission Rules 1.38 and 1.39.62

5. Price Reporting for Block Trades

The Commission also requested comment on whether to require the dissemination of separate pricing information for block trades. 63 The FIA commented that "an exchange submitting a proposed block trading procedure should be afforded the alternatives of including a separate price reporting system or explaining why one is not appropriate or necessary to protect the public interest." The CME commented that "the requirement of a separate ticker for non-standard trades would be both unnecessary and potentially burdensome." The Commission has determined that the reporting and dissemination of special execution transactions under existing reporting systems should be satisfactory so long as special execution transactions are clearly identified as such when reported and disseminated and such transactions are executed only during hours when existing reporting systems are available to make immediate postexecution dissemination. Of course, exchanges may choose to operate a separate but comparable ticker for section 4(c) contract market transactions.

6. Prohibition Against Fraud and Manipulation

Paragraph (c) of proposed section 36.3 would require that rules submitted under this section describe the manner in which the rules or procedures would assure compliance with the provisions of sections 4b and 4c(a) of the Act prohibiting false reports, frontrunning, misuse of information, fictitious sales, wash sales, and abuse of customer orders. This paragraph has been replaced by paragraph (e)(4) of section 36.3.64 This new paragraph requires that rules submitted under this section provide for compliance with section 36.9, which prohibits fraud and manipulation in connection with section 4(c) contract market transactions, except that any trade executed using special execution procedures need not be executed in

⁵⁸ Commission staff reviewed frontrunning prohibitions on other markets. See, e.g., NYSE/CME Joint Frontrunning Interpretation (November 27, 1989) (prohibiting trading to take advantage of material non-public information about a trade in the option, stock, or stock index futures markets that can be expected to have a favorable impact on the trading); SEC Release No. 34-27047 (July 19, 1989)(order approving proposed NYSE rule changes that relate to the Joint CME/NYSE Frontrunning Interpretation); NASD Frontrunning Policy (prohibiting trading to take advantage of material non-public information about a trade in the option or stock markets that can be expected to have a favorable impact on the trading); and NASD Schedule G, Section 4(f)(1), Trading Practices (prohibiting members from buying or selling securities while holding unexecuted market or limit

⁵⁹ For example, in the case of a spread, the trader could comply with the competitive on-floor trading procedures applicable to the non-exempt portion of the spread for both sides, or the trader could leg into the spread transaction using the particular trading procedures which are available to each side of the spread. In any event, the trader could not rely upon the existence of special execution procedures as the basis for non-compliance with the rules which are applicable to trading traditional designated futures and option contracts.

^{60 59} FR at 54147.

⁶¹ In proposing Rule 36.3, the Commission stated the following: "To the extent that a proposal for section 4(c) contract market transactions might provide for trading when the exchange floor is closed, the Commission would still require the immediate report and dissemination of that transaction information." 59 FR at 54147.

⁶² The section 4(c) contract market clearing organization would have an affirmative duty under the Act and Commission Regulations to enforce its rules, and would be subject to recordkeeping, documentation, and other applicable requirements.

⁶³ As an example, the Commission noted that the NYSE and its vendors maintain a separate "block trade" ticker which runs throughout the day and reflects only the size and price of block trades.

⁶⁴ With regard to customer orders, paragraphs (c) and (d) of the regulation provide more guidance as to what activity the Commission would consider to be prohibited.