

for their own accounts, are permitted to enter into transactions in exempt commodities on exempt commercial markets pursuant to section 2(h)(3) of the Act. In order to participate, the floor broker or floor trader must either be an eligible contract participant as that term is defined in section 1a(12) of the Act or have its trades on the exempt commercial market guaranteed by a clearing member that is both a member of a CFTC-registered derivatives clearing organization and is an eligible contract participant.

**DATES:** This order is effective January 16, 2003.

**FOR FURTHER INFORMATION CONTACT:**

Duane C. Andresen, Special Counsel, Division of Market Oversight, Commodity Futures Trading Commission, Three Lafayette Center, 1155 21st Street, NW., Washington, DC 20581. Telephone: 202-418-5492. E-mail: [dandresen@cftc.gov](mailto:dandresen@cftc.gov).

**SUPPLEMENTARY INFORMATION:**

**I. Statutory Background**

Section 1a(11) of the Act, as amended by the Commodity Futures Modernization Act of 2000 (CFMA), Pub. L. No. 106-554, which was signed into law on December 21, 2000, defines the term "eligible commercial entity" (ECE) by listing those eligible contract participants (ECP) <sup>1</sup> that are qualified to be ECEs.<sup>2</sup> Under section 2(h)(3) of the

Act, transactions between ECEs in an "exempt commodity"<sup>3</sup> on an exempt commercial market (ECM) that meet the requirements of 2(h)(3)-(5) are exempt from all but certain limited requirements of the Act.<sup>4</sup> Floor brokers and floor traders, even if determined to fall within the definition of ECP, do not fall within the definition of ECE and, thus, cannot enter into transactions on ECMs. The Act, however, gives the Commission discretion to expand the ECE category. Specifically, section 1a(11)(C) provides that the list of entities defined as ECEs shall include "such other persons as the Commission shall determine appropriate and shall designate by rule, regulation, or order." A determination under this provision that registered floor brokers and floor traders are considered to be ECEs would permit these entities to enter into transactions in exempt commodities on ECMs pursuant to section 2(h)(3) of the Act.

**II. The Petitions**

**A. NYMEX**

By letter dated May 23, 2002, NYMEX submitted a petition for a Commission interpretation pursuant to section 1a(11)(C) of the Act.<sup>5</sup> Specifically,

governmental entity and regularly enters into transactions with respect to the commodity or derivatives transactions in the commodity, subject to certain qualification or total asset requirements; or (3) such other persons as the Commission shall determine appropriate.

<sup>3</sup> Section 1a(14) of the Act defines the term "exempt commodity" to mean a commodity that is not an excluded commodity or an agricultural commodity. Section 1a(13) defines the term "excluded commodity" to mean, among other things, an interest rate, exchange rate, currency, credit risk or measure, debt instrument, measure of inflation, or other macroeconomic index or measure. Although the term "agricultural commodity" is not defined in the Act, section 1a(4) enumerates a non-exclusive list of several agricultural-based commodities and products. The broadest types of commodities that fall into the exempt category are energy and metals products.

<sup>4</sup> Under section 2(h)(3), ECMs are markets that meet the requirements of sections 2(h)(3)-(5) by notifying the Commission of their intention to operate a trading facility in reliance on the exemption and by limiting themselves to transactions: (1) In exempt commodities, (2) entered into on a principal-to-principal basis by ECEs, and (3) executed or traded on an electronic trading facility. An ECM is not a registered entity, but is required to notify the Commission of its intention to operate an electronic trading facility in reliance on the exemption set forth in section 2(h)(3). The notification of operation as an ECM must include several certifications and, pursuant to Commission regulation 36.3(c)(3), a representation that it will require each participant to comply with all applicable law and that it has a reasonable basis for believing that authorized participants are ECEs. Section 2(h)(4) reserves, with respect to transactions eligible for the 2(h)(3) exemption, certain provisions of the Act, including certain anti-fraud and anti-manipulation provisions.

<sup>5</sup> In its petition, NYMEX also requested that the Commission make a determination pursuant to

NYMEX, acting on behalf of its floor brokers, floor traders and clearing firms, requested that the Commission make a determination pursuant to Section 1a(11)(C) of the Act that floor brokers and floor traders, when acting in a proprietary capacity, may enter into certain specified transactions in exempt commodities on ECMs if such Commission registrants have obtained a financial guarantee for such transactions from an Exchange clearing member that is registered with the Commission as an FCM. NYMEX suggested that the permissible transactions be limited to trading in a commodity that either (1) is listed only for clearing on NYMEX,<sup>6</sup> or (2) is listed for trading and clearing on NYMEX and where NYMEX rules provide for the exchange of futures for swaps (EFS) in that contract.<sup>7</sup> NYMEX further proposed that permissible trading be limited to transactions that would subsequently be cleared at NYMEX and represented that NYMEX would have appropriate compliance systems in place to monitor such trading.<sup>8</sup>

section 1a(12)(C) of the Act that floor brokers and floor traders, when acting in a proprietary capacity, be considered to be ECPs when they enter into certain specified transactions. Such a determination would permit NYMEX floor brokers and floor traders to enter into over-the-counter (OTC) transactions in exempt commodities pursuant to section 2(h)(1) of the Act.

<sup>6</sup> By letter dated May 24, 2002, NYMEX filed rule changes that would implement an initiative to provide clearing services for specified energy contracts executed in the OTC markets. NYMEX certified that the rules comply with the Act and the Commission's regulations. Under the provision, NYMEX initially listed 25 contracts that are entered into OTC and accepted for clearing by NYMEX, but are not listed for trading on NYMEX. In connection with the NYMEX initiative, on May 30, 2002, the Commission issued an order pursuant to section 4d of the Act. The order provides that, subject to certain terms and conditions, the NYMEX Clearing House and FCMs clearing through the NYMEX Clearing House may commingle customer funds used to margin, secure, or guarantee transactions in futures contracts executed in the OTC markets and cleared by the NYMEX Clearing House with other funds held in segregated accounts maintained in accordance with section 4d of the Act and the Commission regulations thereunder.

<sup>7</sup> Commodities listed for trading and clearing on NYMEX where NYMEX rules provide for EFSs would include, for example, an OTC natural gas swap to be exchanged for a futures position in the Exchange's Natural Gas futures contract. EFS transactions are permitted at NYMEX pursuant to NYMEX rule 6.21A, Exchange of Futures for, or in Connection with, Swap Transactions. The swap component of the transaction must involve the commodity underlying a related NYMEX futures contract, or a derivative, by-product, or related product of such a commodity. In furtherance of its effort to permit OTC clearing at the Exchange, NYMEX amended the rule to include as eligible EFS transactions "any contract executed off the Exchange that the Exchange has designated as eligible for clearing at the Exchange."

<sup>8</sup> NYMEX also suggested a further limitation on floor members' permissible transactions by not permitting, initially, any transactions in electricity commodities.

<sup>1</sup> Section 1a(12) defines the term ECP by listing those entities and individuals considered to be ECPs. Included generally as ECPs are financial institutions; insurance companies and investment companies subject to regulation; commodity pools and employee benefit plans subject to regulation and asset requirements; other entities subject to asset requirements or whose obligations are guaranteed by an ECP that meets a net worth requirement; governmental entities; brokers, dealers, and futures commission merchants (FCM) subject to regulation and organized as other than natural persons or proprietorships; brokers, dealers, and FCMs subject to regulation and organized as natural persons or proprietorships subject to total asset requirements or whose obligations are guaranteed by an ECP that meets a net worth requirement; floor brokers or floor traders subject to regulation in connection with transactions that take place on or through the facilities of a registered entity or an exempt board of trade; individuals subject to total asset requirements; an investment adviser or commodity trading advisor acting as an investment manager or fiduciary for another ECP, and any other person that the Commission deems eligible in light of the financial or other qualifications of the person.

<sup>2</sup> Section 1a(11) defines the term ECE by listing those entities and individuals considered to be ECEs. Generally, an ECE is an ECP that (1) in connection with its business, demonstrates the ability to make or take delivery of the underlying commodity; incurs risk, in addition to price risk related to the commodity; or is a dealer that regularly provides risk management or hedging services to, or engages in market-making activities with, the foregoing entities with respect to the commodity or derivatives transactions in the commodity; or (2) is other than a natural person or