

into by ECPs in an "excluded commodity" or an "exempt commodity," as those terms are defined by the Act,<sup>3</sup> are exempt from all but certain requirements of the Act.<sup>4</sup> Floor brokers and floor traders are explicitly included in the ECP definition only to the extent that the floor broker or floor trader acts "in connection with any transaction that takes place on or through the facilities of a registered entity or an exempt board of trade, or any affiliate thereof, on which such person regularly trades."<sup>5</sup>

The Act, however, gives the Commission discretion to expand the ECP category as it deems appropriate. Specifically, section 1a(12)(C) provides that the list of entities defined as ECPs shall include "any other person that the Commission determines to be eligible in light of the financial or other qualifications of the person."

## II. The NYMEX Petition

### A. Introduction

By letter dated May 23, 2002, NYMEX submitted a petition for a Commission interpretation pursuant to section 1a(12)(C) of the Act.<sup>6</sup> Specifically, NYMEX, acting on behalf of Exchange

floor members and member clearing firms, requested that the Commission make a determination pursuant to section 1a(12)(C) of the Act that floor members, when acting in a proprietary capacity, may enter into certain specified OTC transactions in exempt commodities pursuant to section 2(h)(1) of the Act 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.<sup>7</sup> NYMEX suggested that the permissible OTC transactions be limited to trading in a commodity that either (1) is listed only for clearing at the Exchange,<sup>8</sup> or (2) is listed for trading and clearing at the Exchange and where Exchange rules provide for the exchange of futures for swaps (EFS) in that contract.<sup>9</sup> NYMEX further proposed that such transactions would be subject to additional conditions and restrictions detailed in the petition and described below.<sup>10</sup>

The NYMEX petition was published in the **Federal Register** for public comment on June 19, 2002.<sup>11</sup> The

Commission received comments from NYMEX and from the Intercontinental Exchange, an ECM. In its comment letter of July 17, 2002, NYMEX reaffirmed its strong interest in the determination requested in the petition and its strong belief that such a determination would have numerous pro-competitive results.<sup>12</sup>

### B. Public Interest Considerations

In its petition, NYMEX stated that the requested determination is best considered against the overall context of the connection between the OTC and exchange markets, and that it is good public policy for the Commission to permit the strengthening of these ties when it is possible to do so. The petition stated that NYMEX has concluded that the ability of its floor members to trade OTC transactions pursuant to an FCM guarantee, particularly OTC swaps involving NYMEX or NYMEX "look-alike" products, is a pivotal component, for the four reasons described below, of the Exchange's business strategy to better serve its customers.

First, NYMEX stated that permitting its floor members to enter into OTC swaps would enhance their ability to provide liquidity to the Exchange's markets. Second, NYMEX stated that access to OTC markets would enhance floor members' ability to make tight markets in new Exchange products that would compete against the standardized look-alike contracts traded in the OTC markets.<sup>13</sup> Third, NYMEX stated that permitting its floor members to enter into EFS transactions with OTC counterparties would expand the pool of potential counterparties for OTC market participants and facilitate liquidity in the OTC marketplace. Finally, with respect to the clearing of OTC transactions, the Exchange intends that the open positions in futures

<sup>3</sup> Section 1a(14) 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> OTC transactions in excluded commodities entered into by ECPs pursuant to Section 2(d)(1) are generally not subject to any provision of the Act. OTC transactions in exempt or excluded commodities that are individually negotiated by ECPs pursuant to section 2(g) are generally not subject to any provision of the Act. OTC transactions in exempt commodities entered into by ECPs pursuant to section 2(h)(1) are generally not subject to any provision of the Act other than anti-manipulation provisions and anti-fraud provisions in certain situations.

<sup>5</sup> Section 1a(12)(A)(x) of the Act.

<sup>6</sup> In its petition, NYMEX also requested that the Commission make a determination pursuant to section 1a(11)(C) of the Act that floor members, when acting in a proprietary capacity, may also be considered to be eligible commercial entities (ECE) when they enter into certain specified transactions. Such a determination would permit NYMEX floor members to enter into transactions in exempt commodities on exempt commercial markets (ECM) pursuant to Section 2(h)(3) of the Act. On January 9, 2003, the Commission issued an order that deems, subject to certain conditions, floor brokers and floor traders who are registered with the Commission, when acting in a proprietary trading capacity, to be ECEs as that term is defined in Section 1a(11) of the Act. That order was published in the **Federal Register** on January 16, 2003. 68 FR 2319 (January 16, 2003).

<sup>7</sup> To qualify for the Section 2(h)(1) exemption, the transaction must: (1) Be in an exempt commodity, (2) be entered into by ECPs, and (3) not be entered into on a trading facility.

<sup>8</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 the Exchange. 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 Commission Regulations thereunder.

<sup>9</sup> EFS transactions are permitted at the Exchange 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>10</sup> NYMEX also suggested a further limitation on floor members' permissible transactions by not permitting, initially, any transactions in electricity commodities.

<sup>11</sup> 67 FR 41698 (June 19, 2002). In that same **Federal Register** release, the Commission also requested comments with respect to NYMEX's request that the Commission make a determination pursuant to section 1a(11)(C) of the Act that floor members, when acting in a proprietary capacity,

may also be considered to be ECEs when they enter into certain specified transactions, as well as a petition filed by the Intercontinental Exchange, Inc., requesting that the Commission issue an order pursuant to section 1a(11) that would expand the ECE category to include floor brokers and floor traders registered as such in the U.S. or with the U.K. Financial Services Authority. As previously noted, on January 9, 2003, the Commission issued an order that deems, subject to certain conditions, floor brokers and floor traders who are registered with the Commission, when acting in a proprietary trading capacity, to be ECEs as that term is defined in section 1a(11) of the Act.

<sup>12</sup> The Commission also received a comment letter, dated September 27, 2002, from the Managing Member of Hudson Capital Group, L.L.C., an options trading group. The commenter strongly supported the petition to allow NYMEX members to trade OTC energy products.

<sup>13</sup> In this regard, the petition states that 80 to 90 percent of energy swaps transactions involve standardized economic terms.