

contracts created by the exchange of an OTC swap for a NYMEX future would be offset by an opposite transaction in the OTC market, thus providing a larger pool of market participants who would enter into a transaction initiating or liquidating a position on the Exchange.

With respect to the economic impact on OTC markets, the petition stated that permitting floor members to trade OTC transactions would increase competition and efficiency, enhance price discovery, and reduce the liquidity risk and the resultant increased market risk that arises from artificial barriers to entry in the markets. NYMEX stated that floor members participating in the OTC markets would perform the same functions they perform in the Exchange market including, among others, enhancing price discovery through the speed and efficiency of market adjustment to new fundamentals and facilitating adjustment of the market price to new information.

C. NYMEX's Analysis of the ECP Definition

In its petition, NYMEX contended that section 1a(12) of the Act supports its requested treatment of floor members as ECPs for a number of reasons. First, NYMEX stated that the treatment of floor members under the section 1a(12) ECP definition appears to be inconsistent in that it treats floor members differently based upon how they organize their businesses. Specifically, floor members who operate as natural persons are only considered ECPs if they satisfy a total asset standard.¹⁴ By comparison, floor members that are organized as partnerships or proprietorships are considered ECPs if they are guaranteed by a specified entity and are not required to meet any total asset requirement.¹⁵ The Exchange

represented that floor trader registrations are generally made in the name of the individual and that exchange membership or seat ownership historically has been held in the name of one individual.¹⁶

Second, the petition stated that the treatment of floor members under Section 1a(12) is inconsistent with the treatment of brokers or dealers or foreign persons (performing similar roles or functions subject to foreign regulation) who are natural persons or proprietorships. Under section 1a(12)(viii), these persons may be considered to be ECPs by meeting either the total assets test of section 1a(12)(xi) or satisfying one of the provisions of 1a(12)(v). Thus, under section 1a(12)(v) a broker or dealer or foreign person operating as a natural person, but not a floor member similarly operating, is permitted to trade OTC products with a guarantee from one of the specified entities and without meeting any total asset requirements.

Third, NYMEX contended that floor members with FCM guarantees should be considered ECPs because the Act permits other entities to use guarantees as a substitute for meeting a total assets requirement. Specifically, NYMEX stated that section 1a(12)(v) of the Act permits a corporation, partnership, proprietorship, organization, trust, or other entity to obtain a guarantee or support via a letter of credit from a financial institution, insurance company, investment company, commodity pool, or governmental entity.

Finally, NYMEX argued that it is reasonable for floor members to rely on FCMs as guarantors.¹⁷ Under section 1a(12)(A)(v), "a corporation, partnership, proprietorship, organization, trust, or other entity" may

incurred by the entity in the conduct of the entity's business."

¹⁶ NYMEX's argument on this point is premised on the assumption that floor brokers and floor traders may alternatively qualify as ECPs under provisions of the ECP definition that specifically refer to "a corporation, partnership, proprietorship, organization, trust, or other entity" (section 1a(12)(A)(v)) and to "an individual" (section 1a(12)(A)(xi)). At present, the Commission is neither accepting nor rejecting the Exchange's interpretation of the ECP definition, but is exercising the authority granted under section 1a(12)(C). As previously noted, the only provision of the ECP definition that specifically refers to floor brokers or floor traders is section 1a(12)(A)(x), which includes within the definition of ECP a floor broker or floor trader 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.

¹⁷ The Commission believes that the FCM guaranteeing the OTC transactions should also have the obligation to clear the transactions at NYMEX.

be considered an ECP if it is guaranteed by a commodity pool with more than \$5 million in total assets. NYMEX pointed out that commodity pools generally are not in the business of conducting risk management for or providing guarantees in connection with trading in the OTC markets. NYMEX stated that if commodity pools are allowed to provide guarantees, then FCMs, who are in the business of monitoring trading by the Exchange members that they guarantee, should be permitted to provide such guarantees for floor members. NYMEX stated that its rules provide that each Exchange clearing member registered as an FCM must maintain minimum working capital of at least \$5 million.¹⁸

D. Trading Restrictions and Exchange Oversight

In its petition, NYMEX represented that it would have appropriate compliance systems in place to monitor OTC trading by Exchange floor members. Because all the permissible OTC trading subsequently would be cleared at the Exchange, NYMEX would be able to obtain information concerning the OTC transactions as part of a review of the exchange of futures for physicals (EFP) or the EFS transaction bringing the transaction to the Exchange for clearing. Failure to comply with a request to provide such information pursuant to the Exchange's EFP or EFS rules would result in a referral to the Exchange's Business Conduct Committee for further action.

NYMEX also suggested that, consistent with the standards which already apply to floor members with respect to their trading on the Exchange, the Commission should provide that floor members' transactions in the permissible contracts that are not executed on a trading facility be executed only pursuant to the section 2(h)(1) exemption. As indicated above, all section 2(h)(1) transactions would be subject to the Commission's anti-manipulation provisions and, in certain situations, anti-fraud provisions.¹⁹ Finally, the Exchange represented that it would agree, as a condition for its members participating in the OTC markets, to limit OTC trading by floor members such that the counterparties to their trades must not be floor members

¹⁸ Pursuant to NYMEX Rule 9.21(B), each clearing member registered with the Commission as an FCM must have and maintain minimum working capital equal to or in excess of the greater of \$5 million or the amount prescribed in Commission Regulation 1.17. As an additional safeguard for the clearing system, the Commission believes that a higher capitalization standard would be appropriate where the clearing member FCM is guaranteeing the OTC transactions of a floor member.

¹⁹ See *supra* note 4.

¹⁴ Section 1a(12)(A)(xi) provides that an individual who meets either of two total asset tests is an ECP. An individual must either have total assets in an amount in excess of \$10,000,000, or of \$5,000,000 and enter "into the agreement, contract, or transaction in order to manage the risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred, by the individual."

¹⁵ Section 1a(12)(A)(v) provides that a corporation, partnership, proprietorship, organization, trust, or other entity that meets one of three tests is an ECP. The entity must either (1) have total assets exceeding \$10,000,000; (2) have its obligations guaranteed or otherwise supported by (subject to total assets or other requirements) a financial institution, insurance company, investment company, commodity pool, or governmental entity; or (3) have a net worth exceeding \$1,000,000 and enter "into an agreement, contract, or transaction in connection with the conduct of the entity's business or to manage the risk associated with an asset owned or liability incurred or reasonably likely to be owned or