

through submission of written data, views and arguments.

To date, ten electronic commercial markets have notified the Commission of their intent to operate as ECMs in reliance on the section 2(h)(3) exemption. The Commission has issued acknowledgment letters to seven ECMs, and is considering the issuance of acknowledgment letters to the other three markets. In view of the Commission's receipt of these section 2(h)(3) notifications, the Commission now is proposing to add specificity to its price discovery rules in several ways. First, the Commission is proposing to adopt two criteria that the Commission will use to determine whether a section 2(h)(3) market performs a significant price discovery function for the underlying cash market. Second, the Commission is proposing to specify the information that must be disseminated by section 2(h)(3) markets that serve such a significant price discovery function. Third, the Commission is proposing certain amendments to its procedures for making a price discovery determination.⁹

A. The Elements of Price Discovery

Price discovery commonly is defined as the process of determining prices through the interaction of buyers and sellers. Prices may be discovered by a single buyer and seller in a privately negotiated bilateral cash market transaction, or through the simultaneous interaction of multiple buyers and sellers in organized markets.

Organized markets, which include futures markets and certain cash markets where trading takes place in accordance with established rules, often perform an important role in facilitating price discovery in the broader cash markets. In particular, these markets facilitate price discovery in cash markets by efficiently incorporating supply and demand information for the underlying commodity into the transaction prices or bids and offers through the operation of a centralized market for the commodity. Thus, the price discovery process on organized markets may significantly enhance the efficiency of the overall cash market.

The extent to which price information is used in establishing prices for cash market transactions that occur outside of the organized markets provides a

relevant factor for determining the contribution of that market to price discovery and for determining whether there is a federal interest in the dissemination of such price information.¹⁰ Such price information may be used in varying degrees to facilitate the establishment of prices and may also serve as one of a number of sources of price information that are consulted by cash market participants in developing bids, offers, or transaction prices. In certain circumstances, such price information may be sufficiently well regarded by the industry that it serves as an important benchmark for cash market participants to consider in setting bids or offers or in negotiating cash market transaction prices.¹¹ In other circumstances, prices discovered on a market may be such an integral and indispensable part of the price determination process in the underlying cash market that bids, offers or cash market transaction prices have a relatively high correlation to the prices discovered on the market. This latter practice is known as price basing.

Price basing is a frequently observed practice in many futures markets and some cash markets. As indicated above, under price basing, commercial entities establish transaction prices for the underlying commodity, or a related commodity, based directly on the prices discovered on an organized market. These entities may or may not trade in the organized market. The cash market transaction prices established through price basing may be either spot or forward prices.

Prices discovered on futures or organized cash markets vary widely with regard to their influence on transaction prices established in broader cash markets. For instance, many long-established organized markets for agricultural, metal, and energy commodities appear to perform a crucial price discovery role for the broader cash markets, as reflected by the widespread practice of price basing in many of these markets. For example, for certain dairy products, the price discovery function of established organized cash markets is so significant that prices established on such markets are extensively used for price basing even though the organized

market's prices may be based on a relatively small number of transactions. Similarly, prices established on actively traded futures markets for commodities like grains, oilseeds, natural gas and petroleum products are extensively used for price basing. In contrast, newly established organized markets may be less likely to perform a significant price discovery function for their associated cash markets in their early stages of development.

As indicated above, the relative significance of prices discovered on an organized market for its underlying cash market is directly related to the extent to which such prices are used in the establishment of transaction prices between commercial entities. As a result of this relationship, the use of a market's prices for price basing, either directly or indirectly, provides observable indicia that the market performs a significant price discovery function that would serve as a basis for such a determination under section 2(h)(4).

B. Proposed Criteria for Making Price Discovery Determination

While the Act authorizes the Commission to make a determination that a section 2(h)(3) market performs a significant price discovery function, it does not define that term or contain criteria to guide that determination. Accordingly, the Commission is proposing to establish the following two alternative criteria for determining that a section 2(h)(3) market performs a significant price discovery function:

(a) Cash market bids, offers or transactions are directly based on or quoted at a differential to the prices generated on the market on a more than occasional basis; or

(b) The market's prices are routinely disseminated in a widely distributed industry publication and are consulted by the industry on a more than occasional basis for pricing cash market transactions.

Under the proposed criteria, a section 2(h)(3) market would be deemed to be performing a significant price discovery function under section 2(h)(4)(D) when a market's prices are used for price basing on a more than occasional basis or are published in a widely distributed industry publication and consulted by the industry on a more than occasional basis for pricing purposes.¹² As

¹⁰ It is this effect that section 2(h)(4) addresses when it provides that information shall be disseminated by an exempt commercial market when "the electronic trading facility performs a significant price discovery function for transactions in the cash market for the commodity underlying any agreement, contract or transaction executed."

¹¹ If the price information discovered on a market is widely respected in an industry, such recognition by the industry in question may lead to the publication of such information in established industry publications.

¹² The Commission is aware of econometric techniques used by academics to measure the relative contribution to the price discovery process by various financial markets trading similar assets (See, e.g., Hasbrouck, J., *One Security, Many Markets: Determining the Contribution to Price Discovery*, Journal of Finance, 50 P 1175-1199, 1995.). However, the Commission understands that these techniques would require price data for both the exempt commercial market and for the

⁹ The types of instruments traded on exempt commercial markets vary widely. Some of these instruments, but not all of them, are subject to the Commission's exclusive jurisdiction. The Commission's proposed rules are directed only to those instruments that are traded in reliance on the section 2(h)(3) exemption and are otherwise subject to the Commission's exclusive jurisdiction.