

Commodity Futures Trading Commission

§ 38.6

conditions of products listed for trading on the facility, prior to their implementation or, notwithstanding the provisions of section 5c(c)(2) of the Act, at anytime thereafter, under the procedures of §§ 40.5 or 40.3 of this chapter, as applicable. A designated contract market may label a product in its rules as, “Listed for trading pursuant to Commission approval,” if the product and its terms or conditions have been approved by the Commission and it may label as, “Approved by the Commission,” only those rules that have been so approved.

(2) Notwithstanding the forty-five day review period for voluntary approval under §§ 40.3(b) and 40.5(b) of this chapter, the operating rules and the terms and conditions of products submitted for voluntary Commission approval under § 40.3 or § 40.5 of this chapter that have been submitted at the same time as an application for contract market designation or an application under § 38.3(a)(2) to reinstate the designation of a dormant contract market as defined in § 40.1 of this chapter, or while one of the foregoing is pending, will be deemed approved by the Commission no earlier than the facility is deemed to be designated or reinstated.

(b) *Self-certification of rules and products.* Rules of a designated contract market and subsequent amendments thereto, including both operational rules and the terms or conditions of products listed for trading on the facility, not voluntarily submitted for prior Commission approval pursuant to paragraph (a) of this section must be submitted to the Commission with a certification that the rule, rule amendment or product complies with the Act or rules thereunder pursuant to the procedures of §§ 40.6 and 40.2 of this chapter, as applicable. *Provided, however,* any rule or rule amendment that would, for a delivery month having open interest, materially change a term or condition of a contract for future delivery in an agricultural commodity enumerated in section 1a(4) of the Act, or of an option on such a contract or commodity, must be submitted to the Commission prior to its implementation for review and approval under § 40.4 of this chapter.

(c) An applicant for designation, or a designated contract market, may request that the Commission consider under the provisions of section 15(b) of the Act any of the contract market’s rules or policies, including both operational rules and the terms or conditions of products listed for trading.

[66 FR 42277, Aug. 10, 2001, as amended at 67 FR 62878, Oct. 9, 2002]

§ 38.5 Information relating to contract market compliance.

(a) Upon request by the Commission, a designated contract market shall file with the Commission such information related to its business as a contract market, including information relating to data entry and trade details, in the form and manner and within the time as specified by the Commission in the request.

(b) Upon request by the Commission, a designated contract market shall file with the Commission a written demonstration, containing such supporting data, information and documents, in the form and manner and within such time as the Commission may specify, that the designated contract market is in compliance with one or more core principles as specified in the request.

(c) Upon a change of ownership of an existing designated contract market, the new owner shall file with the Secretary of the Commission at its Washington, DC, headquarters, a certification that the designated contract market meets all of the requirements of sections 5(b) and 5(d) of the Act and the provisions of this part 38.

[66 FR 42277, Aug. 10, 2001, as amended at 67 FR 62878, Oct. 9, 2002]

§ 38.6 Enforceability.

An agreement, contract or transaction entered into on or pursuant to the rules of a designated contract market shall not be void, voidable, subject to rescission or otherwise invalidated or rendered unenforceable as a result of:

(a) A violation by the designated contract market of the provisions of section 5 of the Act or this part 38; or

(b) Any Commission proceeding to alter or supplement a rule, term or condition under section 8a(7) of the

Act, to declare an emergency under section 8a(9) of the Act, or any other proceeding the effect of which is to alter, supplement, or require a designated contract market to adopt a specific term or condition, trading rule or procedure, or to take or refrain from taking a specific action.

APPENDIX A TO PART 38—APPLICATION GUIDANCE

This appendix provides guidance for applicants for designation as a contract market under sections 5(b) and 6 of the Act and §38.3, on meeting the criteria for designation both initially and on an ongoing basis. The guidance following each designation criterion is illustrative only of the types of matters an applicant may address, as applicable, and is not intended to be a mandatory checklist. Addressing the issues and questions set forth in this appendix would help the Commission in its consideration of whether the application has met the criteria for designation. To the extent that compliance with, or satisfaction of, a criterion for designation is not self-explanatory from the face of the contract market's rules, which may be trading protocols or terms and conditions, the application should include an explanation or other form of documentation demonstrating that the applicant meets the designation criteria of section 5(b) of the Act.

Designation Criterion 1 of section 5(b) of the Act: *IN GENERAL—To be designated as a contract market, the board of trade shall demonstrate to the Commission that the board of trade meets the criteria specified in this appendix.*

A board of trade preparing to submit to the Commission an application for designation as a contract market is encouraged to contact Commission staff for guidance and assistance in preparing an application. Applicants may submit a draft application for review and feedback prior to the submission of an actual application without triggering the application review procedures of §38.3.

Designation Criterion 2 of section 5(b) of the Act: *PREVENTION OF MARKET MANIPULATION—The board of trade shall have the capacity to prevent market manipulation through market surveillance, compliance, and enforcement practices and procedures, including methods for conducting real-time monitoring of trading and comprehensive and accurate trade reconstructions.*

A designation application should demonstrate a capacity to prevent market manipulation, including that the contract market has trading and participation rules deterring abuses and a dedicated regulatory department, or an effective delegation of that function.

Designation Criterion 3 of section 5(b) of the Act: *FAIR AND EQUITABLE TRADING—The board of trade shall establish and enforce trading rules to ensure fair and equitable trading through the facilities of the contract market, and the capacity to detect, investigate, and discipline any person that violates the rules. The rules may authorize—(A) transfer trades or office trades; (B) an exchange of—(i) futures in connection with a cash commodity transaction; (ii) futures for cash commodities; or (iii) futures for swaps; or (C) a futures commission merchant, acting as principal or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if the contract is reported, recorded, or cleared in accordance with the rules of the contract market or a derivatives clearing organization.*

(a) Establishing and enforcing trading rules to ensure fair and equitable trading on a contract market, among other things, includes providing to market participants, on a fair, equitable and timely basis, information regarding, prices, bids and offers, as applicable to the market.

(b) Such trading rules should be designed with adequate specificity.

(c) A contract market that authorizes transfer trades or office trades; an exchange of futures for physicals or futures for swaps; or any other non-competitive transactions, including block trades, should have rules particularly authorizing such transactions and establishing appropriate recordkeeping requirements.

Designation Criterion 4 of section 5(b) of the Act: *TRADE EXECUTION FACILITY—The board of trade shall—(A) establish and enforce rules defining, or specifications detailing, the manner of operation of the trade execution facility maintained by the board of trade, including rules or specifications describing the operation of any electronic matching platform; and (B) demonstrate that the trade execution facility operates in accordance with the rules or specifications.*

(a) An application of a board of trade to be designated as a contract market should include the system's trade-matching algorithm and order entry procedures. An application involving a trade-matching algorithm that is based on order priority factors other than price and time should include a brief explanation of the algorithm.

(b) A designated contract market's specifications on initial and periodic objective testing and review of proper system functioning, adequate capacity and security for any automated systems should be included in its application. A board of trade should submit in the contract market application, information on the objective testing and review carried out on its automated system. The Commission believes that the guidelines issued by the International Organization of Securities Commissions (IOSCO) in 1990

(which have been referred to as the “Principles for Screen-Based Trading Systems”), and adopted by the Commission on November 21, 1990 (55 FR 48670), as supplemented in October, 2000, are appropriate guidelines for an electronic trading facility to apply to electronic trading systems. Any program of objective testing and review of the system should be performed by a qualified independent professional (but not necessarily a third-party contractor).

Designation Criterion 5 of section 5(b) of the Act: *FINANCIAL INTEGRITY OF TRANSACTIONS*—*The board of trade shall establish and enforce rules and procedures for ensuring the financial integrity of transactions entered into by or through the facilities of the contract market, including the clearance and settlement of the transactions with a derivatives clearing organization.*

(a) A designated contract market should provide for the financial integrity of transactions by setting appropriate minimum financial standards for members and non-intermediated market participants, margining systems, appropriate margin forms and appropriate default rules and procedures. Absent Commission action pursuant to its exemptive authority under section 4(c) of the Act, transactions executed on the contract market (other than stock futures products), if cleared, must be cleared through a derivatives clearing organization registered as such with the Commission. The Commission believes ensuring and enforcing the financial integrity of transactions and intermediaries, and the protection of customer funds should include monitoring compliance with the contract market’s minimum financial standards. In order to monitor for minimum financial requirements, a contract market should routinely receive and promptly review financial and related information.

(b) A designated contract market should have rules concerning the protection of customer funds that address appropriate minimum financial standards for intermediaries, the segregation of customer and proprietary funds, the custody of customer funds, the investment standards for customer funds, related recordkeeping procedures and related intermediary default procedures.

Designation Criterion 6 of section 5(b) of the Act: *DISCIPLINARY PROCEDURES*—*The board of trade shall establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market participants that violate the rules of the board of trade, or similar methods for performing the same functions, including delegation of the functions to third parties.*

The disciplinary procedures established by a designated contract market should give the contract market both the authority and ability to discipline and limit or suspend a member’s activities as well as the authority and ability to terminate a member’s activi-

ties pursuant to clear and fair standards. The authority to discipline or limit or suspend the activities of a member or of a market participant could be established in a contract market’s rules, user agreements or other means. An organized exchange or a trading facility could satisfy this criterion for a member with trading privileges but having no, or only nominal, equity, in the facility and for a non-member market participant by expelling or denying future access to such persons upon a finding that such a person has violated the board of trade’s rules.

Designation Criterion 7 of section 5(b) of the Act: *PUBLIC ACCESS*—*The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade.*

A board of trade operating as a contract market may provide information to the public by placing the information on its web site.

Designation Criterion 8 of section 5(b) of the Act: *ABILITY TO OBTAIN INFORMATION*—*The board of trade shall establish and enforce rules that will allow the board of trade to obtain any necessary information to perform any of the functions described in this appendix, including the capacity to carry out such international information-sharing agreements as the Commission may require.*

A designated contract market should have the authority to collect information and documents on both a routine and non-routine basis including the examination of books and records kept by the contract market’s members and by non-intermediated market participants. Appropriate information-sharing agreements could be established with other boards of trade or the Commission could act in conjunction with the contract market to carry out such information sharing.

APPENDIX B TO PART 38—GUIDANCE ON, AND ACCEPTABLE PRACTICES IN, COMPLIANCE WITH CORE PRINCIPLES

1. This appendix provides guidance concerning the core principles with which a board of trade must comply to maintain designation under section 5(d) of the Act and §§ 38.3 and 38.5. The guidance is provided in paragraph (a) following each core principle and it can be used to demonstrate to the Commission core principle compliance, under §§ 38.3(a) and 38.5. The guidance for each core principle is illustrative only of the types of matters a board of trade may address, as applicable, and is not intended to be a mandatory checklist. Addressing the issues and questions set forth in this appendix would help the Commission in its consideration of whether the board of trade is in compliance with the core principles. To the extent that compliance with, or satisfaction of, a core principle is not self-explanatory from the face of the board of trade’s rules,

which may be terms and conditions or trading protocols, an application pursuant to §38.3, or a submission pursuant to §38.5 should include an explanation or other form of documentation demonstrating that the board of trade complies with the core principles.

2. Acceptable practices meeting the requirements of the core principles are set forth in paragraph (b) following each core principle. Boards of trade that follow the specific practices outlined under paragraph (b) for any core principle in this appendix will meet the applicable core principle. Paragraph (b) is for illustrative purposes only, and does not state the exclusive means for satisfying a core principle.

Core Principle 1 of section 5(d) of the Act: *IN GENERAL—To maintain the designation of a board of trade as a contract market, the board of trade shall comply with the core principles specified in this subsection. The board of trade shall have reasonable discretion in establishing the manner in which it complies with the core principles.*

A board of trade applying for designation as a contract market must satisfactorily demonstrate its capacity to operate in compliance with the core principles under section 5(d) of the Act and §38.3. The Commission may require that a board of trade operating as a contract market demonstrate to the Commission that it is in compliance with one or more core principles.

Core Principle 2 of section 5(d) of the Act: *COMPLIANCE WITH RULES—The board of trade shall monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.*

(a) *Application guidance.* (1) A designated contract market should have arrangements and resources for effective trade practice surveillance programs, with the authority to collect information and documents on both a routine and non-routine basis including the examination of books and records kept by the contract market's members and by non-intermediated market participants. The arrangements and resources should facilitate the direct supervision of the market and the analysis of data collected. Trade practice surveillance programs could be carried out by the contract market itself or through delegation to a third party. If the contract market delegates the responsibility of carrying out a trade practice surveillance program to a third party, such third party should have the capacity and authority to carry out such program, and the contract market should retain appropriate supervisory authority over the third party.

(2) A designated contract market should have arrangements, resources and authority for effective rule enforcement. The Commission believes that this should include the au-

thority and ability to discipline and limit, or suspend the activities of a member or market participant as well as the authority and ability to terminate the activities of a member or market participant pursuant to clear and fair standards. An organized exchange or a trading facility could satisfy this criterion for members with trading privileges but having no, or only nominal, equity, in the facility and non-member market participants, by expelling or denying such persons future access upon a determination that such a person has violated the board of trade's rules.

(b) *Acceptable practices.* An acceptable trade practice surveillance program generally would include:

(1) Maintenance of data reflecting the details of each transaction executed on the contract market;

(2) Electronic analysis of this data routinely to detect potential trading violations;

(3) Appropriate and thorough investigative analysis of these and other potential trading violations brought to the contract market's attention; and

(4) Prompt and effective disciplinary action for any violation that is found to have been committed. The Commission believes that the latter element should include the authority and ability to discipline and limit or suspend the activities of a member or market participant pursuant to clear and fair standards that are available to market participants. *See, e.g.* 17 CFR part 8.

Core Principle 3 of section 5(d) of the Act: *CONTRACTS NOT READILY SUBJECT TO MANIPULATION—The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.*

(a) *Application guidance.* Contract markets may list new products for trading by self-certification under §40.2 of this chapter or may submit products for Commission approval under §40.3 and part 40, Appendix A, of this chapter.

(b) *Acceptable practices.* Guideline No. 1, 17 CFR part 40, Appendix A may be used as guidance in meeting this core principle for both new product listings and existing listed contracts.

Core Principle 4 of section 5(d) of the Act: *MONITORING OF TRADING—The board of trade shall monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.*

(a) *Application guidance.* A contract market could prevent market manipulation through a dedicated regulatory department, or by delegation of that function to an appropriate third party.

(b) *Acceptable practices.* (1) An acceptable program for monitoring markets will generally involve the collection of various market data, including information on traders' market activity. Those data should be evaluated on an ongoing basis in order to make an

appropriate regulatory response to potential market disruptions or abusive practices.

(2) The designated contract market should collect data in order to assess whether the market price is responding to the forces of supply and demand. Appropriate data usually include various fundamental data about the underlying commodity, its supply, its demand, and its movement through marketing channels. Especially important are data related to the size and ownership of deliverable supplies—the existing supply and the future or potential supply, and to the pricing of the deliverable commodity relative to the futures price and relative to similar, but non-deliverable, kinds of the commodity. For cash-settled markets, it is more appropriate to pay attention to the availability and pricing of the commodity making up the index to which the market will be settled, as well as monitoring the continued suitability of the methodology for deriving the index.

(3) To assess traders' activity and potential power in a market, at a minimum, every contract market should have routine access to the positions and trading of its market participants and, if applicable, should provide for such access through its agreements with its third-party provider of clearing services. Although clearing member data may be sufficient for some contract markets, an effective surveillance program for contract markets with substantial numbers of customers trading through intermediaries should employ a much more comprehensive large-trader reporting system (LTRS).

Core Principle 5 of section 5(d) of the Act:
POSITION LIMITATIONS OR ACCOUNTABILITY—*To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate.*

(a) *Application guidance.* [Reserved]

(b) *Acceptable practices.* (1) In order to diminish potential problems arising from excessively large speculative positions, and to facilitate orderly liquidation of expiring futures contracts, markets may need to set limits on traders' positions for certain commodities. These position limits specifically may exempt bona fide hedging, permit other exemptions, or set limits differently by markets, by delivery months, or by time periods. For purposes of evaluating a contract market's speculative-limit program, the Commission considers the specified limit levels, aggregation policies, types of exemptions allowed, methods for monitoring compliance with the specified levels, and procedures for enforcement to deal with violations.

(2) Provisions concerning speculative position limits are set forth in part 150. In general, position limits are not necessary for markets where the threat of excessive speculation or manipulation is nonexistent or

very low. Thus, contract markets do not need to adopt speculative position limits for futures markets on major foreign currencies, contracts based on certain financial instruments having very liquid and deep underlying cash markets, and contracts specifying cash settlement where the potential for distortion of such price is negligible. Where speculative position limits are necessary, acceptable speculative-limit levels typically should be set in terms of a trader's combined position in the futures contract plus its position in the related option contract (on a delta-adjusted basis).

(3) A contract market may provide for position accountability provisions in lieu of position limits for contracts on financial instruments, intangible commodities, or certain tangible commodities. Markets appropriate for position accountability rules include those with large open-interest, high daily trading volumes and liquid cash markets.

(4) Spot-month limits should be adopted for markets based on commodities having more limited deliverable supplies or where otherwise necessary to minimize the susceptibility of the market to manipulation or price distortions. The level of the spot limit for physical-delivery markets should be based upon an analysis of deliverable supplies and the history of spot-month liquidations. Spot-month limits for physical-delivery markets are appropriately set at no more than 25 percent of the estimated deliverable supply. For cash-settled markets, spot-month position limits may be necessary if the underlying cash market is small or illiquid such that traders can disrupt the cash market or otherwise influence the cash-settlement price to profit on a futures position. In these cases, the limit should be set at a level that minimizes the potential for manipulation or distortion of the futures contract's or the underlying commodity's price. Markets may elect not to provide all-months-combined and non-spot month limits.

(5) Contract markets should have aggregation rules that apply to those accounts under common control, those with common ownership, i.e., where there is a ten percent or greater financial interest, and those traded according to an express or implied agreement. Contract markets will be permitted to set more stringent aggregation policies. For example, one major board of trade has adopted a policy of automatically aggregating the position of members of the same household, unless they were granted a specific waiver. Contract markets may grant exemptions to their position limits for bona fide hedging (as defined in §1.3(z) of this chapter) and may grant exemptions for reduced risk positions, such as spreads, straddles and arbitrage positions.

(6) Contract markets with many products with large numbers of traders should have an automated means of detecting traders' violations of speculative limits or exemptions. Contract markets should monitor the continuing appropriateness of approved exemptions by periodically reviewing each trader's basis for exemption or requiring a reapplication.

(7) Contract markets should establish a program for effective enforcement of these limits. Contract markets should use their LTRS to monitor and enforce daily compliance with position limit rules. The Commission notes that a contract market may allow traders to periodically apply to the contract market for an exemption and, if appropriate, be granted a position level higher than the applicable speculative limit. The contract market should establish a program to monitor approved exemptions from the limits. The position levels granted under such hedge exemptions generally are based upon the trader's commercial activity in related markets. Contract markets may allow a brief grace period where a qualifying trader may exceed speculative limits or an existing exemption level pending the submission and approval of appropriate justification. A contract market should consider whether it wants to restrict exemptions during the last several days of trading in a delivery month. Acceptable procedures for obtaining and granting exemptions include a requirement that the contract market approve a specific maximum higher level.

(8) Finally, an acceptable speculative limit program should have specific policies for taking regulatory action once a violation of a position limit or exemption is detected. The contract market policy should consider appropriate actions, regardless of whether the violation is by a non-member or member, and should address traders carrying accounts through more than one intermediary.

(9) A violation of contract market position limits that have been approved by the Commission is also a violation of section 4a(e) of the Act. The Commission will consider for approval all contract market position limit rules.

Core Principle 6 of section 5(d) of the Act: *EMERGENCY AUTHORITY—The board of trade shall adopt rules to provide for the exercise of emergency authority, in consultation or cooperation with the Commission, where necessary and appropriate, including the authority to—(A) liquidate or transfer open positions in any contract; (B) suspend or curtail trading in any contract; and (C) require market participants in any contract to meet special margin requirements.*

(a) *Application guidance.* A designated contract market should have clear procedures and guidelines for contract market decision-making regarding emergency intervention in the market, including procedures and guide-

lines to avoid conflicts of interest while carrying out such decision-making. A contract market should also have the authority to intervene as necessary to maintain markets with fair and orderly trading as well as procedures for carrying out the intervention. Procedures and guidelines should also include notifying the Commission of the exercise of a contract market's regulatory emergency authority, minimizing conflicts of interest, and documenting the contract market's decision-making process and the reasons for using its emergency action authority. Information on steps taken under such procedures should be included in a submission of a certified rule under §40.6 of this chapter and any related submissions for rule approval pursuant to §40.5 of this chapter, when carried out pursuant to a contract market's emergency authority.

(b) *Acceptable practices.* As is necessary to address perceived market threats, the contract market, among other things, should be able to impose position limits in particular in the delivery month, impose or modify price limits, modify circuit breakers, call for additional margin either from customers or clearing members, order the liquidation or transfer of open positions, order the fixing of a settlement price, order a reduction in positions, extend or shorten the expiration date or the trading hours, suspend or curtail trading on the market, order the transfer of customer contracts and the margin for such contracts from one member including non-intermediated market participants of the contract market to another, or alter the delivery terms or conditions, or, if applicable, should provide for such actions through its agreements with its third-party provider of clearing services.

Core Principle 7 of section 5(d) of the Act: *AVAILABILITY OF GENERAL INFORMATION—The board of trade shall make available to market authorities, market participants, and the public information concerning—(A) the terms and conditions of the contracts of the contract market; and (B) the mechanisms for executing transactions on or through the facilities of the contract market.*

(a) *Application guidance.* A designated contract market should have arrangements and resources for the disclosure of contract terms and conditions and trading mechanisms to the Commission, market participants and the public. Procedures should also include providing information on listing new products, rule amendments or other changes to previously disclosed information to the Commission, market participants and the public. Provision of all such information to market participants and the public could be by timely placement of the information on a contract market's web site.

(b) *Acceptable practices.* [Reserved]
Core Principle 8 of section 5(d) of the Act: *DAILY PUBLICATION OF TRADING*

INFORMATION—The board of trade shall make public daily information on settlement prices, volume, open interest, and opening and closing ranges for actively traded contracts on the contract market.

(a) *Application guidance.* A contract market should provide to the public information regarding settlement prices, price range, volume, open interest and other related market information for all actively traded contracts, as determined by the Commission, on a fair, equitable and timely basis. The Commission believes that section 5(d)(8) requires contract markets to publicize trading information for any non-dormant contract. Provision of information for any applicable contract could be through such means as provision of the information to a financial information service and by timely placement of the information on a contract market's web site.

(b) *Acceptable practices.* [Reserved]

Core Principle 9 of section 5(d) of the Act: *EXECUTION OF TRANSACTIONS*—The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions.

(a) *Application guidance.* (1) A competitive, open and efficient market and mechanism for executing transactions includes a board of trade's methodology for entering orders and executing transactions.

(2) Appropriate objective testing and review of any automated systems should occur initially and periodically to ensure proper system functioning, adequate capacity and security. A designated contract market's analysis of its automated system should address appropriate principles for the oversight of automated systems, ensuring proper system function, adequate capacity and security. The Commission believes that the guidelines issued by the International Organization of Securities Commissions (IOSCO) in 1990 (which have been referred to as the "Principles for Screen-Based Trading Systems"), and adopted by the Commission on November 21, 1990 (55 FR 48670), as supplemented in October 2000, are appropriate guidelines for a designated contract market to apply to electronic trading systems. Any program of objective testing and review of the system should be performed by a qualified independent professional. The Commission believes that information gathered by analysis, oversight or any program of objective testing and review of any automated systems regarding system functioning, capacity and security should be made available to the Commission.

(3) A designated contract market that determines to allow block trading should ensure that the block trading does not operate in a manner that compromises the integrity of prices or price discovery on the relevant market.

(b) *Acceptable practices.* A professional that is a certified member of the Information Systems Audit and Control Association experienced in the industry would be an example of an acceptable party to carry out testing and review of an electronic trading system.

Core Principle 10 of section 5(d) of the Act: *TRADE INFORMATION*—The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market.

(a) *Application guidance.* A designated contract market should have arrangements and resources for recording of full data entry and trade details and the safe storage of audit trail data. A designated contract market should have systems sufficient to enable the contract market to use the information for purposes of assisting in the prevention of customer and market abuses through reconstruction of trading.

(b) *Acceptable practices.* (1) The goal of an audit trail is to detect and deter customer and market abuse. An effective contract market audit trail should capture and retain sufficient trade-related information to permit contract market staff to detect trading abuses and to reconstruct all transactions within a reasonable period of time. An audit trail should include specialized electronic surveillance programs that would identify potentially abusive trades and trade patterns, including, for instance, withholding or disclosing customer orders, trading ahead, and preferential allocation. An acceptable audit trail must be able to track a customer order from time of receipt through fill allocation or other disposition. The contract market must create and maintain an electronic transaction history database that contains information with respect to transactions executed on the designated contract market.

(2) An acceptable audit trail should include the following: original source documents, transaction history, electronic analysis capability, and safe storage capability. A contract market whose audit trail satisfies the following acceptable practices would satisfy Core Principle 10.

(i) Original source documents. Original source documents include unalterable, sequentially identified records on which trade execution information is originally recorded, whether recorded manually or electronically. For each customer order (whether filled, unfilled or cancelled, each of which should be retained or electronically captured), such records reflect the terms of the order, an account identifier that relates back to the account(s) owner(s), and the time of

order entry. (For floor-based contract markets, the time of report of execution of the order should also be captured.)

(ii) Transaction history. A transaction history which consists of an electronic history of each transaction, including (a) all data that are input into the trade entry or matching system for the transaction to match and clear; (b) the categories of participants for which such trades are executed, including whether the person executing a trade was executing it for his/her own account or an account for which he/she has discretion, his/her clearing member's house account, the account of another member, including market participants present on the floor, or the account of any other customer; (c) timing and sequencing data adequate to reconstruct trading; and (d) the identification of each account to which fills are allocated.

(iii) Electronic analysis capability. An electronic analysis capability that permits sorting and presenting data included in the transaction history so as to reconstruct trading and to identify possible trading violations with respect to both customer and market abuse.

(iv) Safe storage capability. Safe storage capability provides for a method of storing the data included in the transaction history in a manner that protects the data from unauthorized alteration, as well as from accidental erasure or other loss. Data should be retained in accordance with the record-keeping standards of Core Principle 17.

Core Principle 11 of section 5(d) of the Act: *FINANCIAL INTEGRITY OF CONTRACTS—The board of trade shall establish and enforce rules providing for the financial integrity of any contracts traded on the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization), and rules to ensure the financial integrity of any futures commission merchants and introducing brokers and the protection of customer funds.*

(a) *Application guidance.* Clearing of transactions executed on a designated contract market other than transactions in security futures products, should be provided through a Commission-registered derivatives clearing organization. In addition, a designated contract market should maintain the financial integrity of its transactions by maintaining minimum financial standards for its members and non-intermediated market participants and by having default rules and procedures. The minimum financial standards should be monitored for compliance purposes. The Commission believes that in order to monitor for minimum financial requirements, a designated contract market should routinely receive and promptly review financial and related information from its members. Rules concerning the protection of customer funds should address the segregation of customer and proprietary funds, the cus-

tody of customer funds, the investment standards for customer funds, related record-keeping and related intermediary default procedures. The contract market should audit its members that are intermediaries for compliance with the foregoing rules as well as applicable Commission rules. These audits should be conducted consistent with the guidance set forth in Division of Clearing and Intermediary Oversight Interpretations 4-1 and 4-2. A contract market may delegate to a designated self-regulatory organization responsibility for receiving financial reports and for conducting compliance audits pursuant to the guidelines set forth in § 1.52 of this chapter.

(b) *Acceptable Practices.* [Reserved]

Core Principle 12 of section 5(d) of the Act: *PROTECTION OF MARKET PARTICIPANTS—The board of trade shall establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants.*

(a) *Application guidance.* A designated contract market should have rules prohibiting conduct by intermediaries that is fraudulent, noncompetitive, unfair, or an abusive practice in connection with the execution of trades and a program to detect and discipline such behavior. The contract market should have methods and resources appropriate to the nature of the trading system and the structure of the market to detect trade practice abuses.

(b) *Acceptable practices.* [Reserved]

Core Principle 13 of section 5(d) of the Act: *DISPUTE RESOLUTION—The board of trade shall establish and enforce rules regarding and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries.*

(a) *Application guidance.* A designated contract market should provide customer dispute resolution procedures that are fair and equitable and make them available on a voluntary basis, either directly or through another self-regulatory organization, to customers that are non-eligible contract participants.

(b) *Acceptable practices.* (1) Under Core Principle 13, a designated contract market is required to provide for dispute resolution mechanisms that are appropriate to the nature of the market.

(2) In order to satisfy acceptable standards, a designated contract market should provide a customer dispute resolution mechanism that is fundamentally fair and is equitable. An acceptable customer dispute resolution mechanism would:

(i) Provide the customer with an opportunity to have his or her claim decided by an objective and impartial decision-maker,

(ii) Provide each party with the right to be represented by counsel, at the party's own expense.

(iii) Provide each party with adequate notice of the claims presented against him or her, an opportunity to be heard on all claims, defenses and permitted counterclaims, and an opportunity for a prompt hearing.

(iv) Authorize prompt, written, final settlement awards that are not subject to appeal within the contract market, and

(v) Notify the parties of the fees and costs that may be assessed.

(3) The use of such procedures should be voluntary for customers who are not eligible contract participants, and could permit counterclaims as provided in §166.5 of this chapter.

(4) If the designated contract market also provides a procedure for the resolution of disputes that do not involve customers (*i.e.*, member-to-member disputes), the procedure for resolving such disputes must be independent of and shall not interfere with or delay the resolution of customers' claims or grievances.

(5) A designated contract market may delegate to another self-regulatory organization or to a registered futures association its responsibility to provide for customer dispute resolution mechanisms, provided, however, that, if the designated contract market does delegate that responsibility, the contract market shall in all respects treat any decision issued by such other organization or association as if the decision were its own including providing for the appropriate enforcement of any award issued against a delinquent member.

Core Principle 14 of section 5(d) of the Act: *GOVERNANCE FITNESS STANDARDS—The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other persons with direct access to the facility (including any parties affiliated with any of the persons described in this core principle).*

(a) *Application guidance.* (1) A designated contract market should have appropriate eligibility criteria for the categories of persons set forth in the Core Principle that should include standards for fitness and for the collection and verification of information supporting compliance with such standards. Minimum standards of fitness for persons who have member voting privileges, governing obligations or responsibilities, or who exercise disciplinary authority are those bases for refusal to register a person under section 8a(2) of the Act. In addition, persons who have governing obligations or responsibilities, or who exercise disciplinary authority, should not have a significant history of serious disciplinary offenses, such as those that would be disqualifying under §1.63 of this chapter. Members with trading privileges but having no, or only nominal, equity, in the facility and non-member market par-

ticipants who are not intermediated and do not have these privileges, obligations, responsibilities or disciplinary authority could satisfy minimum fitness standards by meeting the standards that they must meet to qualify as a "market participant." Natural persons who directly or indirectly have greater than a ten percent ownership interest in a designated contract market should meet the fitness standards applicable to members with voting rights.

(2) The Commission believes that such standards should include providing the Commission with fitness information for such persons, whether registration information, certification to the fitness of such persons, an affidavit of such persons' fitness by the contract market's counsel or other information substantiating the fitness of such persons. If a contract market provides certification of the fitness of such a person, the Commission believes that such certification should be based on verified information that the person is fit to be in his or her position.

(b) *Acceptable practices.* [Reserved]

Core Principle 15 of section 5(d) of the Act: *CONFLICTS OF INTEREST—The board of trade shall establish and enforce rules to minimize conflicts of interest in the decision making process of the contract market and establish a process for resolving such conflicts of interest.*

(a) *Application guidance.* The means to address conflicts of interest in decision-making of a contract market should include methods to ascertain the presence of conflicts of interest and to make decisions in the event of such a conflict. In addition, the Commission believes that the contract market should provide for appropriate limitations on the use or disclosure of material non-public information gained through the performance of official duties by board members, committee members and contract market employees or gained through an ownership interest in the contract market.

(b) *Acceptable practices.* [Reserved]

Core Principle 16 of section 5(d) of the Act: *COMPOSITION OF BOARDS OF MUTUALLY OWNED CONTRACT MARKETS—In the case of a mutually owned contract market, the board of trade shall ensure that the composition of the governing board reflects market participants.*

(a) *Application guidance.* The composition of a mutually-owned contract market should fairly represent the diversity of interests of the contract market's market participants.

(b) *Acceptable practices.* [Reserved]

Core Principle 17 of section 5(d) of the Act: *RECORDKEEPING—The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the Commission for a period of 5 years.*

(a) *Application guidance.* [Reserved]

(b) *Acceptable practices.* Section 1.31 of this chapter governs recordkeeping obligations

under the Act and the Commission's regulations thereunder. In order to provide broad flexible performance standards for record-keeping, §1.31 was updated and amended by the Commission in 1999. Accordingly, §1.31 itself establishes the guidance regarding the form and manner for keeping records.

Core Principle 18 of section 5(d) of the Act: *ANTITRUST CONSIDERATIONS—Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall endeavor to avoid—(A) adopting any rules or taking any actions that result in any unreasonable restraints of trade; or (B) imposing any material anti-competitive burden on trading on the contract market.*

(a) *Application guidance.* An entity seeking designation as a contract market may request that the Commission consider under the provisions of section 15(b) of the Act any of the entity's rules, including trading protocols or policies, and including both operational rules and the terms or conditions of products listed for trading, at the time of designation or thereafter. The Commission intends to apply section 15(b) of the Act to its consideration of issues under this core principle in a manner consistent with that previously applied to contract markets.

(b) *Acceptable practices.* [Reserved]

[66 FR 42277, Aug. 10, 2001, as amended at 67 FR 62352, Oct. 7, 2002]

PART 39—DERIVATIVES CLEARING ORGANIZATIONS

Sec.

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APPENDIX A TO PART 39—APPLICATION GUIDANCE AND COMPLIANCE WITH CORE PRINCIPLES

AUTHORITY: 7 U.S.C. 7b as amended by Appendix E of Pub. L. 106-554, 114 Stat. 2763A-365.

SOURCE: 66 FR 45609, Aug. 29, 2001, unless otherwise noted.

§ 39.1 Scope.

The provisions of this part apply to any derivatives clearing organization as defined under section 1a(9) of the Act which is registered or deemed to be

registered with the Commission as a derivatives clearing organization, is required to register as such with the Commission pursuant to section 5b(a) of the Act, or which voluntarily applies to register as such with the Commission pursuant to section 5b(b) or otherwise.

§ 39.2 Exemption.

A derivatives clearing organization and the clearing of agreements, contracts and transactions on a derivatives clearing organization are exempt from all Commission regulations except for the requirements of this part 39 and §§1.3, 1.12(f)(1), 1.20, 1.24, 1.25, 1.26, 1.27, 1.29, 1.31, 1.36, 1.38(b), part 40 and part 190 of this chapter, and as applicable to the agreement, contract or transaction cleared, parts 15 through 18 of this chapter. The foregoing reserved regulations are applicable to a derivatives clearing organization and its activities as though they were set forth in this section and included specific reference to derivatives clearing organizations. Any reference to the term "clearinghouse" or "clearing organization" contained in the regulations shall be deemed to refer to a derivatives clearing organization.

§ 39.3 Procedures for registration.

(a) *Registration by application.* An organization shall be deemed to be registered as a derivatives clearing organization sixty days after receipt by the Commission of an application for registration as a derivatives clearing organization unless notified otherwise during that period, or, as determined by Commission order, registered upon conditions, if:

(1) The application is labeled as being submitted pursuant to this part 39;

(2) The applicant represents that it will operate in accordance with the definition of derivatives clearing organization contained in section 1a(9) of the Act;

(3) The application includes a copy of the applicant's rules;

(4) To the extent it is not self evident from the applicant's rules, the application demonstrates how the applicant is able to satisfy each of the core principles specified in section 5b(c)(2) of the Act;