



October 16, 2009

## CFTC to Review Whether Certain ICE Contracts Are “Significant Price Discovery Contracts”

The U.S. Commodity Futures Trading Commission (CFTC) recently issued notices of its intent (NOIs) to determine whether over a dozen financial natural gas and power contracts traded on the IntercontinentalExchange, Inc. (ICE) are “significant price discovery contracts” (SPDCs) and therefore subject to additional regulatory and reporting requirements. These NOIs were issued pursuant to recent amendments to the Commodity Exchange Act (CEA)<sup>1</sup> intended to close the so-called “Enron Loophole.”<sup>2</sup> Comments on the NOIs are due on October 21, 2009 and October 26, 2009.

### I. Background

The NOIs are the latest step in closing the so-called “Enron Loophole” created by the Commodity Futures Modernization Act of 2000 (CFMA).<sup>3</sup> The CFMA established a number of exemptions and exclusions from CFTC regulation under the CEA for certain swaps and other derivatives that are traded bilaterally or on electronic trading facilities, including an exemption for transactions in “exempt commodities” traded on exempt commercial markets (ECMs), such as ICE.<sup>4</sup> The CFTC Reauthorization Act of 2008 (Reauthorization Act)<sup>5</sup> grants the CFTC regulatory authority over ECMs through the addition of a new Section 2(h)(7) of the CEA,<sup>6</sup> and authorizes the CFTC to require ECMs with SPDCs to adopt position limits and accountability levels and to require reporting of large trader positions in SPDCs. In addition, the Reauthorization Act amends the definition of “registered entity” in Section 1a(29) to include ECMs with SPDCs, so that trading in SPDCs on ECMs is subject to all of the provisions of the CEA, and all CFTC rules and regulations thereunder, applicable to other CFTC-registered entities.

On March 16, 2009, the CFTC issued a [final rule](#) implementing the above provisions of the Reauthorization Act, which became effective April 22, 2009. As explained in more detail below, the March 16 Rule sets forth the process by which the CFTC will determine whether a given contract is an SPDC and the additional regulatory and reporting requirements to which such SPDCs will be subject.

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### II. Overview of the March 16 Rule and CFTC Regulation of SPDCs

#### A. CFTC Determination That ECM Contract Is An SPDC

The March 16 Rule adds a new Section 36.3(c) and Appendix A to Part 36 of the CFTC's regulations,<sup>7</sup> which sets forth the procedures and guidance, respectively, that the CFTC will use to determine whether an ECM agreement, contract or transaction is an SPDC. The four criteria are as follows:

- **Price Linkage.** The extent to which the contract “uses or otherwise relies on a daily or final settlement price, or other major price parameter” of agreements, contracts, or transactions traded or listed on a “designated contract market” (DCM) or “derivatives transaction execution facility” (DTEF), or of another SPDC, “to value a position, transfer or convert a position, cash or financially settle a position, or close out a position.”<sup>8</sup>
- **Arbitrage.** The extent to which the price for the agreement, contract, or transaction is “sufficiently related” to the price of one or more contracts traded or listed on a DCM or DTEF, or of another SPDC, “so as to permit participants to effectively arbitrage between the markets by maintaining positions or executing trades in the contracts on a frequent and recurring basis.”<sup>9</sup>
- **Material Price Reference.** The extent to which, “on a frequent and recurring basis, bids, offers, or transactions in a commodity are directly based on, or are determined by referencing, the prices generated by agreements, contracts or transactions being traded or executed on the electronic trading facility.”<sup>10</sup>
- **Material Liquidity.** “The extent to which the volume of agreements, contracts or transactions ... is sufficient to have a material effect on other agreements, contracts or transactions” traded or listed on a DCM, DTEF, or ECM.<sup>11</sup>

Whenever the CFTC learns of a potential SPDC (whether through its own information collection and market surveillance activities, notification by an ECM, or through unsolicited information from market participants), the CFTC will make a determination of whether the contract is an SPDC pursuant to the procedures set forth in Section 36.3(c)(3) of the CFTC's regulations.<sup>12</sup>

#### B. Core Principles Applicable to SPDCs

Section 2(h)(7)(C) of the CEA establishes the following nine “core principles” for SPDCs. These principles are derived from the core principles applicable to DCMs (*i.e.*, CFTC-regulated futures exchanges such as the New York Mercantile Exchange (NYMEX)). The March 16 Rule adds a new Appendix B to Part 36 of the CFTC's regulations, in which the CFTC provides guidance regarding compliance with these core principles and acceptable practices for meeting these requirements.<sup>13</sup>



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- **Contracts Not Readily Susceptible to Manipulation.** Upon determination that a contract is an SPDC, an electronic facility must self-certify the terms and conditions of the SPDC under Section 36.3(c)(4) of the CFTC's regulations.<sup>14</sup> Subsequent changes to rules governing trading in SPDCs must be self-certified to the CFTC or submitted to the CFTC for review pursuant to Section 40.5 or Section 40.6 of the CFTC's regulations.<sup>15</sup>
- **Monitoring of Trading.** The electronic trading facility must monitor trading in SPDCs to prevent market manipulation, price distortion, and disruption of the delivery or cash-settlement process through market surveillance, enforcement mechanisms, real-time trade monitoring, and access to participants' trade and position data.
- **Ability to Obtain Information.** The electronic trading facility must establish and enforce rules that allow it to obtain any information necessary to perform this function, to provide information to the CFTC upon request, and to carry out international information-sharing agreements that the CFTC may require.
- **Position Limitations or Accountability.**<sup>16</sup> To reduce the threat of market manipulation and to facilitate orderly trading, the electronic trading facility must be able to adopt position limits<sup>17</sup> and position accountability levels<sup>18</sup> for speculators in SPDCs, which take into account positions in agreements, contracts, or transactions that are treated by other derivative clearing organizations (whether registered or not) as fungible with the SPDC.<sup>19</sup>
- **Emergency Authority.** The electronic trading facility must have in place rules for the exercise of emergency authority, in consultation or cooperation with the CFTC, including the authority to liquidate open positions in SPDCs and to suspend or curtail trading in SPDCs.
- **Daily Publication of Trading Information.** Electronic trading facilities must make available to the public, on a daily basis, information on settlement prices, price range, trading volume, open interest, and other trade-related information specified by the CFTC.
- **Compliance with Rules.** Electronic trading facilities must monitor and enforce compliance with its rules (including the ability to collect information and examine books and records), which may be carried out by the facility itself or through delegation or contracting-out such responsibilities to a third party.
- **Conflicts of Interest.** The electronic trading facility must establish and enforce rules to minimize conflicts of interest in the decision-making process and establish a process for resolving such conflicts of interest between and among the facility's self-regulatory responsibilities, commercial interests, and the interests of its management, members, owners, market participants, and other industry participants.
- **Antitrust Considerations.** The electronic trading facility must endeavor to avoid any actions that result in any unreasonable restraints of trade or impose a material anticompetitive burden on trading.



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Following the issuance of a CFTC order finding that a given electronic trading facility executes or trades an SPDC, the electronic trading facility must demonstrate that it complies with the above core principles with respect to that SPDC. The facility has 90 days to demonstrate compliance if the CFTC order is the first one finding that one of the facility's contracts is an SPDC. For subsequent SPDCs trading on that facility, the facility has 30 days to demonstrate compliance. The materials that must be submitted are set forth in Section 36.3(c)(4) of the CFTC's regulations.<sup>20</sup>

### C. Reporting Requirements

The March 16 Rule subjects ECMs with SPDCs to the CFTC's generally applicable reporting requirements applicable to DCMs and DTEFs. In particular:

- ECMs must provide "clearing member"<sup>21</sup> reports for SPDCs to the CFTC pursuant to CFTC Rule 16.00<sup>22</sup> and must submit to the CFTC and publicly disseminate option deltas and aggregated trading data on a daily basis pursuant to CFTC Rule 16.01;
- ECM clearing members that clear SPDCs (regardless of registration status) are required to file position reports for large SPDC positions when a customer's positions exceed the contract reporting levels of Rule 15.03(b) pursuant to CFTC Rule 17.00 and to identify the owners of such reportable SPDC positions pursuant to CFTC Rule 17.01;
- SPDC traders are subject to the "special call" provisions of Part 18 of the CFTC's regulations for reportable positions in excess of the contract reporting levels of CFTC Rule 15.03(b); and
- Clearing members for SPDCs, SPDC traders, and ECMs listing SPDCs are subject to the special call provisions of Part 21 of the CFTC's regulations.

In addition, the March 16 Rule adds a new CFTC Rule 16.02, which requires ECMs with SPDCs (along with DCMs and DTEFs) to provide daily trade and supporting data reports, including time and sales data, reference files, and other information specified by the CFTC.<sup>23</sup>

The March 16 Rule also subjects ECMs with SPDCs to additional reporting requirements that are not applicable to DCMs and DTEFs. New Section 36.3(b)(1) of the CFTC's regulations requires each ECM to provide to the CFTC specified information regarding the agreements, contracts, or transactions listed on the facility for exempt commodities and other information explaining why it qualifies for this exemption under CEA Section 2(h)(3).<sup>24</sup>

### III. ICE Natural Gas and Power Contracts Covered by the NOIs

In the two NOIs published in the *Federal Register* on October 6, 2009, the CFTC states its intent to determine whether multiple financial power contracts traded on ICE for the Mid-Columbia trading hub in Washington state<sup>25</sup> and the SP-15 and NP-15 trading hubs in California<sup>26</sup> are SPDCs. In two further NOIs published in the *Federal Register* on October 9, 2009, the CFTC states its intent to determine whether eleven natural gas financial basis contracts<sup>27</sup> traded on ICE for the following locations are SPDCs:



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the TETCO M-3 trading hub in the Northeast;<sup>28</sup> the San Juan Basin trading hub near the Colorado-New Mexico border;<sup>29</sup> the Dominion-South trading hub in Western Pennsylvania;<sup>30</sup> the Malin, Oregon trading hub near the California-Oregon border;<sup>31</sup> the Permian Basin trading hub near the Texas-New Mexico border;<sup>32</sup> the AECO trading hub in Alberta, Canada;<sup>33</sup> the Chicago, Illinois trading hub;<sup>34</sup> the TCO trading hub near the West Virginia-Pennsylvania border;<sup>35</sup> the Waha trading hub in Southwestern Texas;<sup>36</sup> the Transco Zone 6 trading hub near New York City;<sup>37</sup> the Houston Ship Channel trading hub near Houston, Texas;<sup>38</sup> the NGPL TXOK trading hub in Eastern Texas;<sup>39</sup> and the PG&E Citygate trading hub near San Francisco, California.<sup>40</sup>

In addition to the ICE contracts covered by the recently issued NOIs, the CFTC previously issued NOIs regarding two other financial contracts. First, on June 12, 2009, the CFTC issued a NOI to undertake a determination of whether the ICE cash-settled NYMEX “lookalike” natural gas swap is an SPDC.<sup>41</sup> Second, on August 20, 2009, the CFTC issued an NOI regarding the Carbon Financial Instrument offered on the Chicago Climate Exchange, Inc.<sup>42</sup> The CFTC has not yet made a final determination as to whether these two contracts are SPDCs.

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*This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice.*

<sup>1</sup> 7 U.S.C. §§ 1 *et seq.* (2006).

<sup>2</sup> Final Rule, *Significant Price Discovery Contracts on Exempt Commercial Markets*, 74 Fed. Reg. 12,178 (Mar. 23, 2009) (March 16 Rule). *See also* Notice of Proposed Rulemaking, *Significant Price Discovery Contracts on Exempt Commercial Markets*, 73 Fed. Reg. 75,888 (Dec. 12, 2008) (Proposed Rule).

<sup>3</sup> Pub.L. 106-554, 114 Stat. 2763 (2000).

<sup>4</sup> 7 U.S.C. § 2(h)(3) (2006). “Exempt commodities” eligible to be traded on ECMs include all commodities except agricultural and “excluded commodities” (which are primarily financial commodities such as interest rate products), including energy products, metals, chemicals, air emission allowances, paper pulp, and barge freight rates. Under the CFMA, ECMs are not required to be licensed by or registered with the CFTC and are subject to the CEA’s antifraud and anti-manipulation provisions, as well as limited recordkeeping and reporting requirements. *See* Proposed Rule at 75,889.

<sup>5</sup> Food, Conservation and Energy Act of 2008, Title XIII Pub. L. 110-246, 122 Stat. 1624 (2008).

<sup>6</sup> 7 U.S.C. § 2(h)(7) (2006).

<sup>7</sup> 17 C.F.R. § 36.3(c) and 17 C.F.R. Pt. 36, App. A.

<sup>8</sup> 17 C.F.R. § 36.3(c)(1)(i).

<sup>9</sup> 17 C.F.R. § 36.3(c)(1)(ii).

<sup>10</sup> 17 C.F.R. § 36.3(c)(1)(iii).

<sup>11</sup> 17 C.F.R. § 36.3(c)(1)(iv).

<sup>12</sup> 17 C.F.R. § 36.3(c)(3). Before making any final SPDC determination, the CFTC will publish a notice of such intent in the *Federal Register* seeking comments within 30 days (or such other time specified by the CFTC), and it will then issue an order within a “reasonable period” after the close of the comment period explaining its determination.



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<sup>13</sup> 17 C.F.R. Pt. 36, App. B.

<sup>14</sup> 17 C.F.R. § 36.3(c)(4).

<sup>15</sup> 17 C.F.R. §§ 40.5, 40.6.

<sup>16</sup> The Final Rule does not establish position limits or accountability limits for uncleared trades, as proposed in the Proposed Rule. The CFTC noted that several commenters on the Proposed Rule expressed concern about the CFTC's proposed guidance regarding acceptable practices for position limits or accountability levels relating to uncleared trades. The CFTC concluded that these comments raised complex issues that warrant further consideration and that, consequently, it would not require compliance with this core principle with respect to uncleared trades until these issues have been examined fully. The CFTC intends to complete a review and issue a separate rulemaking in the next several months. *See* Final Rule at 12,180-81.

<sup>17</sup> The CFTC requires the adoption of spot-month position limits for SPDCs to minimize the susceptibility of the market to manipulation or price distortion, including squeezes, corners, and other abusive trading practices.

<sup>18</sup> Position accountability levels apply to non-spot month positions and are a means for an electronic trading facility to monitor traders' positions that may threaten orderly trading. The CFTC directs such facilities to set target accountability threshold levels (for individual non-spot months and for all-months-combined levels). These levels may be exceeded, but once breached, the facility must initiate an inquiry to determine whether the trader's activity is justified and is not intended to manipulate the market.

<sup>19</sup> Where the electronic facility lists an SPDC that is economically equivalent to another SPDC or to one or more contracts traded on a DCM or DTEF, the facility must set the position limit or accountability level for its SPDC at the same level as those specified for the economically-equivalent contract(s). For SPDCs that are not economically equivalent to an existing contract, the CFTC guidelines state that the appropriate spot-month position limit for a physical delivery market is no more than 25 percent of the estimated deliverable supply, whereas for cash-settled SPDCs, the spot month position limit should be set at a level that minimizes the potential for market manipulation or distortion in the SPDC, related futures and options contracts, in other SPDCs or fungible agreements, contracts, or transactions, and in the underlying commodity itself. The CFTC directs that the accountability levels (for both non-spot individual months and all-months-combined levels) for SPDCs that are not economically equivalent to an existing contract shall be no greater than 10 percent of the average combined futures and delta-adjusted option month-end open interest for the most recent calendar year.

<sup>20</sup> 17 C.F.R. § 36.3(c)(4).

<sup>21</sup> A "clearing member" is "any person who is a member of, or enjoys the privilege of clearing trades in his own name through, the clearing organization of" a DCM, DTEF, or registered entity. 17 C.F.R. § 15.00(b).

<sup>22</sup> The daily clearing member report must include, for each clearing member (by proprietary and customer account), the following information, to be provided separately for each futures contract (by commodity and contract date) and for each option (by put/call type, expiration date, strike price, and underlying futures contract or physical commodity): total long and total short open contracts; total quantity of contracts bought and sold that day; quantity of contracts for each purchase and sale on that day and the name of the clearing member that made the purchase or sale; and, for futures, the quantity of the commodity for which delivery notices were issued and the quantity for which delivery notices were stopped on that day. 17 C.F.R. § 16.00(a).

<sup>23</sup> 17 C.F.R. § 16.02.

<sup>24</sup> 17 C.F.R. § 36.3(b)(1).

<sup>25</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the Mid-C Financial Peak Contract; Mid-C Financial Peak Daily Contract; Mid-C Financial Off-Peak Contract; and Mid-C Financial Off-Peak Daily Contract, Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function*, 74 Fed. Reg. 51,261 (Oct. 6, 2009).



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<sup>26</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the SP-15 Financial Day-Ahead LMP Peak Contract; SP-15 Financial Day-Ahead LMP Peak Daily Contract; SP-15 Financial Day-Ahead LMP Off-Peak Daily Contract; SP-15 Financial Day-Ahead LMP Peak Contract; SP-15 Financial Swap Real-Time LMP–Peak Daily Contract; SP-15 Financial Day-Ahead LMP Off-Peak Contract; NP-15 Financial Day-Ahead LMP Peak Daily Contract; NP-15 Financial Day-Ahead LMP Off-Peak Daily Contract, Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 51,264 (Oct. 6, 2009).*

<sup>27</sup> A financial basis contract is a derivative instrument whose value is based on the difference between the NYMEX monthly natural gas futures contract settlement price for a given month and the monthly index price at a specified location for that same month.

<sup>28</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the TETCO-M3 Financial Basis Contract, Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 52,186 (Oct. 9, 2009).*

<sup>29</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the San Juan Financial Basis Contract, Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 52,188 (Oct. 9, 2009).*

<sup>30</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the Dominion-South Financial Basis Contract, Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 52,190 (Oct. 9, 2009).*

<sup>31</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the Malin Financial Basis Contract, Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 52,192 (Oct. 9, 2009).*

<sup>32</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the Permian Financial Basis Contract, Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 52,192 (Oct. 9, 2009).*

<sup>33</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the AECO Financial Basis Contract, Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 52,196 (Oct. 9, 2009).*

<sup>34</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the Chicago Financial Basis Contract, Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 52,198 (Oct. 9, 2009).*

<sup>35</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the TCO Financial Basis Contract, Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 52,200 (Oct. 9, 2009).*

<sup>36</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the Waha Financial Basis Contract, Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 52,202 (Oct. 9, 2009).*

<sup>37</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the Zone 6-NY Financial Basis Contract, Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 52,204 (Oct. 9, 2009).*

<sup>38</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the HSC Financial Basis Contract, Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 52,206 (Oct. 9, 2009).*



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<sup>39</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the NGPL TXOK Financial Basis Contract, Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function*, 74 Fed. Reg. 52,208 (Oct. 9, 2009).

<sup>40</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the PG&E Citygate Financial Basis Contract, Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function*, 74 Fed. Reg. 52,2010 (Oct. 9, 2009).

<sup>41</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the Henry Financial LD1 Fixed Price Contract Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function*, 74 Fed. Reg. 28,028 (June 12, 2009). The CFTC has previously indicated that the ICE “lookalike” swap performs a significant price discovery function. *See generally Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets* (Oct. 2007) (ECM Report), available at: [http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/pr5403-07\\_ecmreport.pdf](http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/pr5403-07_ecmreport.pdf). *See also* Final Rule at 12,178.

<sup>42</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the Carbon Financial Instrument Offered for Trading on the Chicago Climate Exchange, Inc. Performs a Significant Price Discovery Function*, 74 Fed. Reg. 42,052 (Aug. 20, 2009).