Application of U.S. Futures Exchange, L.L.C. for Designation as a Contract Market Pursuant to Sections 5 and 6(a) of the Commodity Exchange Act

Staff Memorandum

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February 2, 2004

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Division of
Market Oversight

February 2, 2004

DESIGNATION MEMORANDUM

To:	The Commission
From:	The Division of Market Oversight
Subject:	Application of the U.S. Futures Exchange, L.L.C. (USFE) for Designation as a Contract Market Pursuant to Sections 5 and 6(a) of the Commodity Exchange Act
Recommendation:	Staff recommends that the Commission designate the USFE as a contract market; simultaneously approve the USFE's Amended and Restated Bylaw Sections 1.1, 2.1-2.7, 3.1-3.4, 3.6-3.16, 3.26, 5.1-5.7, 6.1-6.10, 7.1-7.2, 8.1-8.2, 8.4, 9.1-9.8, 10.1-10.5, and 12.1-12.3; and USFE Rules 101-103, 201-208, 301-315, 401-418, 501-504, 506-510, 601-617, 701, and 801-805; and issue the attached Order of Designation and Letter.
Concurring:	Office of the General Counsel The Division of Clearing and Intermediary Oversight
Consulting:	The Division of Enforcement
Responsible Staff:	Duane Andresen (x5492)

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I. Executive Summary

The U.S. Futures Exchange, L.L.C. (USFE or Exchange),[1] a limited liability company formed pursuant to the Delaware Limited Liability Company Act, has applied to the Commodity Futures Trading Commission (Commission or CFTC) for designation as a contract market (DCM) for the automated trading of futures and options on futures contracts. The USFE is owned 80% by U.S. Exchange Holdings, Inc. (USEH), a Delaware corporation that is a separately capitalized wholly-owned subsidiary of Eurex Frankfurt, AG[2], and 20% by Exchange Place Holdings, L.P. (EPH), a Delaware limited partnership.[3] The USFE contracts would trade on an enhanced version of the a/c/e trading system,[4] known as the USFE Trading System (Trading System), which is a fully automated electronic trading system. For centralized-market trading, the Trading System is anonymous from order entry through clearing, and accepts, disseminates, and matches orders. For off-centralized-market trading, the USFE's rules provide

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[1] The USFE is also known, and often referred to in press releases and elsewhere, as Eurex US.

[2] Eurex Frankfurt AG operates Eurex Deutschland (Eurex), a futures exchange currently operating in Frankfurt, Germany, and its clearing organization, Eurex Clearing AG. Eurex Frankfurt AG is a wholly-owned subsidiary of Eurex Zurich AG, a Swiss exchange entity. Eurex Zurich AG is owned in equal parts by two parents - the SWX Swiss Exchange and Deutsche Boerse AG. SWX Swiss Exchange is owned by an association of 54 of its members, primarily banks but also including other financial institutions. Deutsche Boerse AG is a publicly traded company listed on the Frankfurt Stock Exchange and is owned by more than 36,000 shareholders. It is majority owned by U.K. and U.S. institutional investors, its largest shareholder is a U.S. institutional investor, and the two shareholders that each owns approximately a 5% share of the company are both U.S. entities. For a further description of the ownership of the USFE, *see* The USFE Corporate Affiliation Chart in Section III and the discussion in Section VI below.

[3] Exchange Place Holdings, L.P., formerly known as BTEX Holdings, L.P., consists of 17 shareholders, many of which were direct or indirect shareholders of the BrokerTec Futures Exchange, L.L.C. (BTEX). Among others, these shareholders include the following firms: Citigroup Global Markets, Inc., Deutsche Bank Securities, Inc., Goldman Sachs & Co., Lehman Brothers, Inc., Man Financial, Inc., Morgan Stanley & Co. Inc., and Refco LLC. For a discussion of the terms under which these firms became equity partners in the USFE, and the related Revenue Commission Agreements, *see* Section VI below.

[4] Eurex had operated the a/c/e trading system in the U.S. as part of a joint venture with the Chicago Board of Trade (CBOT) since 2000. That joint venture ended December 31, 2003.

for block trading, exchanges of futures for physicals (EFPs), exchanges of futures for swaps (EFSs), and volatility trading.[5]

The USFE has entered into an agreement with The Clearing Corporation (C Corp)[6] to provide clearing and settlement services for the Exchange. C Corp, registered with the Commission as a derivatives clearing organization (DCO), will settle and clear contracts traded on the Trading System or entered through the trading facilities. The Exchange has contracted with the National Futures Association (NFA) to assist it in carrying out various self-regulatory responsibilities with respect to, among other things, market, trade practice and financial surveillance, and investigative and disciplinary functions. The NFA would also provide its arbitration forum for the resolution of customer/member disputes and member/member disputes.

The Exchange has submitted to the Commission a proposed trade-matching algorithm, procedures, bylaws and rules pertaining to the USFE governance, disciplinary procedures, trading standards, recordkeeping requirements, membership and other agreements, and various other materials to meet the requirements for a board of trade seeking initial designation as a contract market. The Exchange also has submitted agreements that would establish C Corp as the entity to clear and settle contracts and the NFA as the entity to assist the USFE in carrying out self-regulatory responsibilities for contracts traded on the USFE, including compliance, surveillance, and dispute resolution services.[7] In addition to receiving these written materials, Commission staff visited the premises of the USFE, C Corp and the NFA on December 2, 2003, and of the USFE on December 10, 2003, to receive demonstrations of the operations of the USFE.

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[5] *See* Section VI below for a discussion of volatility trading.

[6] C Corp is the successor organization to The Board of Trade Clearing Corporation.

[7] *See* USFE submissions dated September 16, 2003, to January 30, 2004.

The USFE's application has attracted substantial interest from the public, including support from Federal regulators and end users and criticism from two contract markets, the CBOT and the Chicago Mercantile Exchange (CME). The Commission afforded interested parties two separate opportunities to comment on the application and the Committee on Agriculture of the U.S. House of Representatives convened a hearing to consider the merits of the application on November 6, 2003. Staff has carefully reviewed all comments that have been submitted from the public and from other Federal agencies.

Some of the concerns raised by the commenters relate to future business plans that the USFE has publicly announced but has not included in the application. Those business plans largely relate to clearing services and trading incentive programs. Due to significant public interest in the possible implementation of these business plans, both the USFE and C Corp voluntarily offered certain undertakings to the Commission that are designed to ensure that the Commission has an adequate opportunity to review and, as appropriate, approve such plans before they are implemented. Some of the undertakings are incorporated in the recommended Order of Designation.

Based upon its review of the entire application and the complete record in this matter, including all public comments received by the Commission with respect to the application, staff has determined that the USFE's application demonstrates compliance with the designation criteria of Section 5(b) of the Commodity Exchange Act (Act), the core principles of Section 5(d) of the Act, and the common provisions of Section 5c(b) of the Act regarding designation of contract markets. Accordingly, staff recommends that the Commission designate the USFE as a contract market and simultaneously approve the following the USFE Bylaws and Rules: The USFE Amended and Restated Bylaw Sections 1.1, 2.1-2.7, 3.1-3.4, 3.6-3.16, 3.26, 5.1-5.7, 6.1-

6.10, 7.1-7.2, 8.1-8.2, 8.4, 9.1-9.8, 10.1-10.5, and 12.1-12.3; and USFE Rules 101-103, 201-208, 301-315, 401-418, 501-504, 506-510, 601-617, 701, and 801-805.

II. Procedural Background

The Commission received the USFE application on September 16, 2003. The USFE submitted the application pursuant to the contract market designation procedures set forth in Commission Regulation 38.3. On October 14, 2003, the Commission announced its determination to consider the application outside the timeframe set forth in Commission Regulation 38.3. The Commission explained that it was taking this action "in order to ensure that it has an adequate opportunity to consider fully the issues presented by the Exchange's application."[8] The application now is being reviewed pursuant to the 180-day review procedures of Section 6 of the Act. That review period expires on March 15, 2004.

The Commission posted the USFE's application on its website on September 16, 2003, with a request for comment.[9] This first comment period ended on October 16, 2003, after being extended once in response to requests from interested parties.[10] The Commission received ten comment letters in response to this request for comment. The Commission also received responses to the public comment letters from the NFA and the USFE, and later received a letter from the CBOT responding to the USFE's responsive comments. The Commission reopened the

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[8] *See* Commission Statement on U.S. Futures Exchange (Oct. 14, 2003) (available on the Commission's website at http://www.cftc.gov/opa/press03/opausfuturesstatement.htm).

[9] In addition to posting the USFE's original application submission of September 16, 2003, the Commission has posted on its website copies of the supplemental material submitted by the Exchange that are not subject to a confidentiality request. Those postings have generally been made available upon the date of Commission receipt or shortly thereafter.

[10] *See* CFTC Release 4844-03 (Sept. 26, 2003) (available on the Commission's website at http://www.cftc.gov/opa/press3/opa4844-03.htm).

public comment period on December 10, 2003, for a 10-day period.[11] Twenty-seven comment letters were received following the reopening of the comment period.

Pursuant to Section 2(a)(9)(B) of the Act,[12] the Commission forwarded copies of the application to the Board of Governors of the Federal Reserve System (Federal Reserve) and the Department of the Treasury (Treasury) on November 5, 2003.[13] At that time, the Commission also provided the Federal Reserve and the Treasury with copies of draft specifications of the futures and option contracts involving securities issued by the U.S. Treasury that the USFE has stated it intends to offer. In its transmittal letter, the Commission advised the Federal Reserve and the Treasury that, although the products were not formally before the Commission for its approval, the Commission nevertheless would welcome their comments and would take them into consideration during the review of the application and the subsequent certification of the products. Subsequently, also pursuant to Section 2(a)(9)(B) of the Act, the Commission forwarded copies of a draft revenue commission agreement (RCA) and several other documents related to the USFE designation application that were submitted voluntarily to the Commission

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[11] The Commission reopened the public comment period after it had scheduled a public hearing and then canceled that hearing due to scheduling conflicts of some market participants. *See* CFTC Press Release 4872-03 (Dec. 11, 2003) (available on the Commission's website at http://www.cftc.gov/opa/press03/opa4872-03.htm).

[12] Section 2(a)(9)(B) of the Act provides, in part, that

> When a board of trade applies for designation or registration as a contract market or derivatives transaction execution facility involving transactions for future delivery of any security issued or guaranteed by the United States or any agency thereof, the Commission shall promptly deliver a copy of such application to the Department of the Treasury and the Board of Governors of the Federal Reserve System. The Commission may not designate or register a board of trade as a contract market or derivatives transaction execution facility based on such application until forty-five days after the date the Commission delivers the application to such agencies or until the Commission receives comments from each of such agencies on the application, whichever period is shorter. Any comments received by the Commission from such agencies shall be included as part of the public record of the Commission's designation proceeding….

[13] *See* Letters dated November 5, 2003 from Richard Shilts, Deputy Director, Division of Market Oversight, to Patrick M. Parkinson, Associate Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System, and to Timothy Bitsberger, Deputy Assistant Secretary for Federal Finance, Department of the Treasury.

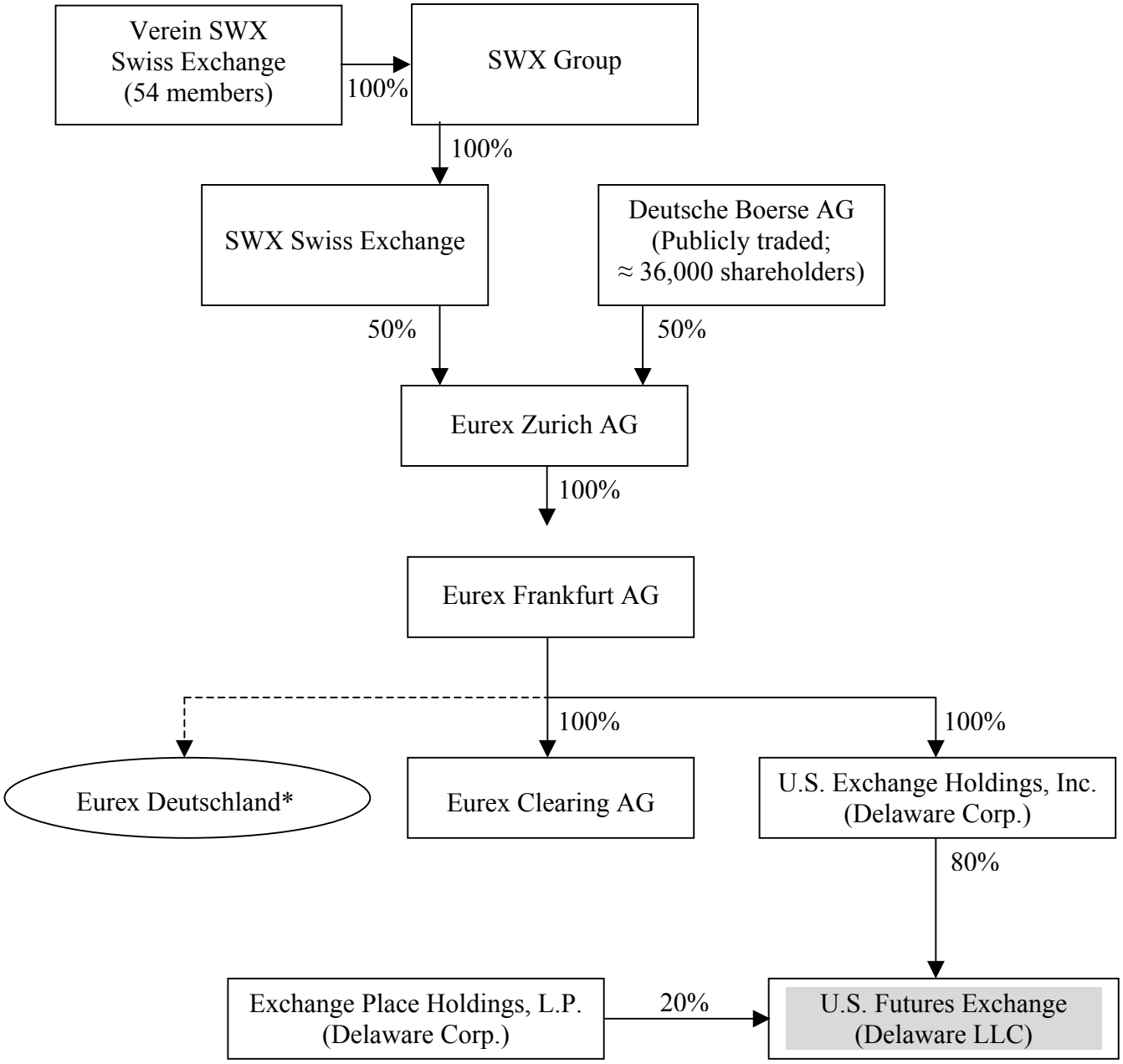
by the BTEX.[14] The Treasury and the Federal Reserve filed comments with the Commission on December 18 and 19, 2003, respectively.

The remainder of this memorandum consists of a chart depicting the relationship of the USFE to its corporate affiliates and a discussion of the application and the comments thereon. The corporate affiliation chart is in Section III. Sections IV and V describe in detail how the applicant meets the requirements of the designation criteria and core principles. Section VI includes a discussion of noteworthy and novel issues presented by the ownership of the USFE, the RCAs that the USFE has entered into with seven U.S. financial firms, and the Exchange's Trading System and trading facilities. Section VII summarizes and provides the staff's analysis of the comments received in response to the application. Section VIII discusses certain undertakings of the USFE and C Corp relating to clearing services and incentive trading programs that are contained in the Order of Designation. Finally, Section IX lists the key supporting documents to this memorandum.

[14] *See* Letters dated December 17, 2003 from Michael Gorham, Director, Division of Market Oversight, to Patrick M. Parkinson, Associate Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System, and to Timothy Bitsberger, Deputy Assistant Secretary for Federal Finance, Department of the Treasury.

III. The USFE's Corporate Affiliation Chart

The following chart reflects the relationship of the USFE to its corporate affiliates:



* Eurex Deutschland is a company under German public law. It is operated by Eurex Frankfurt AG.

IV. Analysis of the USFE's Application for Compliance with Designation Criteria

This section is divided into three columns. The first column identifies a specific designation criterion. The center column identifies the component(s) of the USFE's application that addresses that designation criterion. The third column describes, in summary fashion and on an exception basis, staff's analysis with respect to how the component(s) of the USFE's application addresses the designation criterion.

CONTRACT MARKET CRITERIA FOR DESIGNATION	THE USFE PROPOSAL	STAFF ANALYSIS
Sec. 5(a) Applications – A board of trade applying to the Commission for designation as a contract market shall submit an application to the Commission that includes any relevant materials and records the Commission may require consistent with this Act.	Combined USFE Submissions dated September 16, 2003, through January 30, 2004.	Acceptable *See* List of key supporting documents
Sec. 5(b) CRITERIA FOR DESIGNATION		
Designation Criterion *1* *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 subsection.	The USFE submissions dated September 16, 2003 through January 30, 2004, that include the USFE Contract Market Application (Overview), Regulatory Chart, Certificate of Formation, Amended and Restated Bylaws (Bylaws), Amended and Restated Limited Liability Company Agreement, Rulebook, Membership Applications and Agreement, the USFE/NFA Regulatory Services Agreement (RSA), Revenue Commission Agreement (RCA), Market Supervision Trading Business Procedures, General Services Agreement with Eurex Frankfurt AG, Service Level Agreement with Deutsche Boerse AG, the USFE/C Corp Clearing Services Agreement (Clearing Services Agreement), Disaster Recovery Plan, User Guide, Response to CFTC Technical Questionnaire, Information Manual and System Overview, Operations Manual, Front End Installation Guide, Front End Operations Guide, Internal Trading Manual, Security Manual, Security Coordinator Manual, the USFE Responses to CFTC Staff Questions (submitted November 4, 2003), the USFE Letter to the Commission dated November 18, 2003, and the USFE Responses to CFTC Staff Questions (submitted December 5, 2003, January 20, 2004, and January 23, 2004).	Acceptable *See* List of key supporting documents
Designation Criterion 2 *Prevention of Market Manipulation* – The board of trade shall have the capacity to prevent market manipulation through market	USFE Rules 308 (prohibited conduct); 308(g) (bars manipulation, or the attempted manipulation, of the price, or the cornering, any contract or underlying commodity).	Acceptable The USFE has entered into an agreement with the NFA to assist it in carrying out various self regulatory

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surveillance, compliance, and enforcement practices and procedures, including methods for conducting real-time monitoring of trading and comprehensive and accurate trade reconstructions.	RSA. Overview p. 4. Regulatory Chart. Membership Agreement p. 2. Market Supervision Trading Business Procedures. Responses to CFTC Staff Questions (submitted November 4, 2003). USFE Letter to the Commission dated November 18, 2003 p. 15.	assist it in carrying out various self-regulatory responsibilities with respect to market surveillance, compliance, and enforcement. The NFA has entered into similar agreements with the Merchants' Exchange, OnExchange, Island Futures Exchange and BrokerTec (BTEX), four markets that have been approved as designated contract markets by the Commission. NFA conducted market surveillance for BTEX during the period of November 2001-November 2003. A DMO Rule Enforcement Review covering the period November 30, 2001 to November 30, 2002 confirmed the effectiveness of NFA's performance at BTEX. The NFA has established procedures designed to reveal various trading abuses, including attempts to manipulate futures prices. The USFE Market Supervision staff will monitor overall activity in each market on a real-time basis and the USFE's Compliance Department will oversee the NFA's surveillance activities. The NFA would provide the USFE with data regarding positions of large traders, deliverable supplies and futures and cash prices. The NFA, together with Exchange staff, will monitor trading to prevent manipulations, price distortions, and disruptions of the delivery or cash settlement process. The market surveillance conducted by the NFA is specified in Schedule A of the RSA. The USFE's Trading System would automatically create a full and accurate record of all entries into the system, including all bids, offers and orders, and all matched transactions, allowing for a comprehensive audit trail.
Designation Criterion 3 *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 shall maintain 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	USFE Rules 307(m) (requires due diligence in receiving and handling customer orders); 307(n) (requires priority for customer orders); 308(a) (prohibits violations of the Act, Commission Regulations, or other applicable laws); 308(b) (prohibits violations of the USFE or C Corp Bylaws, Rules and procedures); 308(f) (prohibits dissemination of false, misleading or knowingly inaccurate information); 308(g) (prohibits manipulation or attempts to manipulate); 308(h) (prohibits furnishing false or misleading information); 308(k) (prohibits entering bids or offers into the Trading System other than in good faith); 308(o) (prohibits entering into a	Acceptable The USFE has established trading rules to detect and deter trading abuses. The USFE has entered into an agreement with the NFA to assist it in carrying out various self-regulatory responsibilities with respect to market surveillance, trade practice surveillance, disciplinary functions, and arbitration. (See RSA.) The USFE's Market Supervision staff will monitor overall activity in each market on a real-time basis and the USFE's Compliance Department will oversee the NFA's surveillance activities. The NFA, together with the

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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.	in good faith); 308(o) (prohibits entering into a transaction on the Trading System which is not competitively executed on the Trading System except as may be permitted under the Rules); 308(p) (prohibits conduct or practices inconsistent with just and equitable principles of trade); 403 (Orders); 406 (Cross Trades and Pre-negotiated Trades); 410 (authorizes transfer trades); 415 (authorizes block trades); 416 (authorizes EFPs); 417 (authorizes EFSs); 418 (authorizes Vola trades); Part 6 (Disciplinary Proceedings). RSA. Regulatory Chart. Membership Agreement. Responses to CFTC Staff Questions (submitted November 4, 2003). USFE Letter to the Commission dated November 18, 2003. USFE Responses to CFTC Staff Questions (submitted December 5, 2003).	Exchange staff, will monitor trading to prevent manipulations, price distortions, and disruptions of the delivery or cash settlement process. The NFA would monitor for, among other things, compliance with trading rules. See Schedule A of the RSA. USFE Rule 418 (Volatility [Vola] Trading Facility – Exchange of Futures for Options) establishes an electronic Vola Trading Facility through which volatility trades may be effected. See Noteworthy or Novel Issues at Section VI below for further discussion of the Vola Trading Facility. USFE Rule 403(c) (Strategy Board Trading) establishes a methodology for trading various combinations of options or options and futures contracts on the Trading System. See Noteworthy or Novel Issues at Section VI below for further discussion of Strategy Board Trading.
Designation Criterion 4 *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.	USFE Rule 404 (Execution of Transactions). Responses to CFTC Staff Questions (submitted November 4, 2003). Responses to CFTC Technical Questionnaire. USFE Letter to the Commission dated November 18, 2003. User Guide. Information Manual and System Overview. Operations Manual. Front End Installation Guide. Front End Operations Guide. Internal Trading Manual. Security Manual. Security Coordinator/Master Terminal Operator Manual. Disaster Tolerance Concept for Exchange Trading Systems Operated by Deutsche Boerse Systems.	Acceptable Orders entered into the Trading System would be executed in accordance with either a price time priority algorithm or a price pro-rata algorithm as determined by the USFE on a contract-by-contract basis. The price time priority algorithm gives first priority to orders at the best prices, and then gives priority among orders at the same price based on time of entry into the Trading System. The price pro-rata algorithm assigns first priority on the basis of price and fills orders at the same price on a pro-rata basis. These algorithms are similar to those previously approved by the Commission for other electronic trading systems. Under the pro-rata matching principle, if the total order volume of best price orders and quotes contained in the order book exceeds the volume of an incoming order or quote, the quotes and orders contained in the order book will, after rounding down to form a whole contract, first be allocated to and matched with the incoming order and quote on the basis of the percentage share they represent of the total order volume available in the Trading System at that price. To the extent that the incoming order could not be fully allocated and executed on this basis, the

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		portion thereof that could not be executed would be randomly allocated to and matched with the orders and quotes contained in the order book. If the total order volume of best price orders and quotes contained in the order book does not exceed the volume of the incoming order or quote, the best price orders and quotes contained in the order book will be fully allocated and executed. That portion of the incoming order or quote that could not be executed in this manner would be matched according to the pro-rata matching principle among the next best price orders and quotes contained in the order book. The USFE has provided extensive documentation regarding their system and its operation, both during this review period and during previous periods in which the Commission acquired relevant technical information. That documentation includes system architecture diagrams and descriptions, system design specifications, security policies and procedures, system development life cycle management plans, quality control policies and procedures, capacity planning guidelines, and disaster recovery plans. The USFE employs a formal change management program to ensure the quality of its trading system. The development process is controlled at each stage by a central quality assurance group, spans a 3-month period, and includes an acceptance test phase of both functional and regression testing and a simulation phase in which members are involved. The USFE has provided the Commission the results of their several testing regimens, which include functional, technical, and regression testing. Those results clearly indicate that all errors encountered have been corrected and the system meets the design specifications. The USFE provided a functional demonstration of the Trading System on December 2, 2003 for Commission staff from the Divisions of Market Oversight and Clearing and Intermediary Oversight. This demonstration verified acceptable operation of the Trading System.

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		During a site visit on December 10, 2003, to the USFE's primary and backup data centers and operations areas, Commission IT staff were able to observe first-hand the trading system and its supporting infrastructure, the staff and operational control facilities supporting the operation, and the physical security and environmental controls provided by the USFE facilities. All technical and operational information obtained by Commission staff supports a conclusion that the USFE's proposed electronic trading system will comply with the IOSCO principles for screen-based trading and verifies that the system operates in accordance with the rules and specifications provided.
Designation Criterion 5 *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.	RSA, Attachment A. Clearing Services Agreement. USFE Rules 101 (Definition of Clearing Member); 302 (Eligibility for Membership); 307 (Duties of Members); 314 (Termination of Membership); 503 (Clearance Authorization); 611 (Penalties Imposed as a Result of Disciplinary Proceedings). Responses to CFTC Staff Questions (submitted January 23, 2004). C Corp Rules 201 (Qualification of Members); 204 (Financial Statements of Members); 207 (Notices Required of Members); 301 (Effect of Clearance).	Acceptable. The USFE has entered into an agreement with C Corp to provide clearing and settlement and other services for the Exchange. C Corp, registered with the Commission as a DCO, will process and guarantee in its own name contracts traded on the USFE. The USFE has also entered into a Regulatory Services Agreement with NFA, and Attachment A thereto lists the tasks NFA will perform for the USFE, including review of periodic financial statements of members and ongoing and daily financial surveillance. USFE Rule 503 requires every transaction to be effected through an authorized clearing member. USFE Rule 101 defines "authorized clearing member" to mean a USFE member who is authorized by the C Corp to clear and settle transactions. A USFE member that is not an authorized clearing member must have in effect, prior to trading, an agreement with an authorized clearing member that will guarantee and clear the transactions made for its own account or for the accounts of its customers. USFE Rule 302 requires each applicant for USFE membership to have adequate financial resources and credit, and to be registered, licensed or otherwise permitted by the relevant government authority to trade on the USFE. C Corp Rule 201 sets forth the

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		qualification criteria for clearing members. Among other criteria, a clearing member must demonstrate that: (a) it meets, at the time of admission and maintains thereafter, minimum capital requirements established by the C Corp; and (b) it has established satisfactory relationships with, and has designated to the C Corp, an approved settlement bank for confirmation and payment of all margins and settlements to the C Corp. USFE Rule 307(l) requires all members that are FCMs and IBs to, at all times, comply with Commission minimum financial requirements, and for members that are Securities and Exchange Commission (SEC) broker-dealers to, at all times, comply with the minimum financial requirements set forth by the SEC. Among other duties, USFE Rule 307 requires each member to: (i) notify the USFE of a failure to maintain segregated funds where the member is a clearing member or FCM; (ii) maintain a record, in a manner consistent with Commission regulations, showing all of the details and terms of all transactions executed on the USFE; and (iii) make and file reports in accordance with Commission regulations. Under C Corp Rule 207, a clearing member is required to notify the C Corp immediately upon the occurrence of one of several events, including: (a) any material adverse change to the member's financial condition, including but not limited to a decline in the net capital of 20% or more (reference to Commission Rule 1.17); and (b) any proposed material reduction in the member's operating capital, including the incurrence of a contingent liability which would materially affect the member's capital or other representations contained in any financial statement submitted to the C Corp. C Corp Rule 307 requires a member to establish separate accounts for the purpose of maintaining customer funds in accordance with applicable law. C Corp has established a Guaranty Fund to secure the obligations of its members. Guaranty Fund requirements are set at a minimum level of $200,000 per member (except for grandfathered sole proprietors whose minimum requirement is $75,000). Clearing members

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		may satisfy their obligations with forms of collateral including but not limited to C Corp stock.
Designation Criterion 6 *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.	USFE Rules Part 6 (Disciplinary Proceedings); 203 (Disciplinary Committee); 205 (Compliance Department). Overview. RSA. Responses to CFTC Staff Questions (submitted November 4, 2003).	Acceptable. Disciplinary procedures would be consistent with Commission regulations and interpretive guidance regarding designation criteria and core principles. Pursuant to Part 6 of the Exchange's rules, the Disciplinary Committee may discipline members, after notice and opportunity for a hearing before a hearing panel of the Committee, by taking the following actions: issue a censure or reprimand; impose a fine; limit the positions that the respondent may carry or hold; suspend trading and/or clearing privileges and/or deny future access, either directly or indirectly, in whole or in part, to the Exchange's market for such period as the hearing panel of the Disciplinary Committee may determine; suspend as a clearing member or as a member; terminate as a clearing member or as a member; and impose such other penalty as the hearing panel of the Disciplinary Committee in its discretion shall deem appropriate. Pursuant to the RSA, the NFA staff will perform the functions of the Enforcement Staff under the direction of the Chief of the Compliance Department, an Exchange employee, as described in Part 6. The Enforcement Staff would investigate possible rule violations and present written investigation reports to the Disciplinary Committee, composed of officers or employees appointed by the CEO, which would authorize the issuance of a notice of charges, based on a finding of probable cause, to commence a disciplinary proceeding. The Disciplinary Committee that hears the charges would include a panel of three Exchange officers or employees. The USFE's Compliance Department, which would include the NFA Enforcement Staff, would fill the prosecutorial function in these proceedings.
Designation Criterion 7 *Public Access* – The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade.	Regulatory Chart p. 4. Responses to CFTC Staff Questions (submitted November 4, 2003).	Acceptable The USFE represents that it would post on its website the USFE Bylaws, Rules, and contract specifications, including the terms and conditions of all Exchange

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		contracts and the mechanisms for executing transactions on or through the Trading System, as well as changes to its Bylaws, Rules and contract specifications.
Designation Criterion 8 *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 subsection, including the capacity to carry out such international information-sharing agreements as the Commission may require.	USFE Rules 307(c) (requires that members make and file reports in accordance with Commission Regulations); 307(d) (requires that members comply with Commission recordkeeping requirements); 307(e), (f), and (g) (require members to keep records and make reports and respond to information requests from the USFE). Membership Application. Regulatory Chart p. 4. Responses to CFTC Staff Questions (submitted November 4, 2003).	Acceptable Members would be required to file reports and furnish timely information and testimony as prescribed or as requested by the USFE. The USFE has represented that it will enter into appropriate information sharing agreements, including the International Information Sharing Memorandum of Understanding and Agreement dated March 15, 1996. The USFE has further represented that it would participate in the Commission's Exchange Database System project and would work with the Commission in order to provide trading information to the project.

V. Analysis of the USFE's Application for Compliance with Core Principles

This section is divided into three columns. The first column identifies a specific core principle. The center column identifies the component(s) of the USFE's application that addresses that core principle. The third column describes, in summary fashion and on an exception basis, staff's analysis with respect to how the component(s) of the USFE's application addresses the core principle.

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Sec. 5c(b) Common Provisions Applicable to Registered Entities - **(1) In General** – A contract market or derivatives transaction execution facility may comply with any applicable core principle through delegation of any relevant function to a registered futures association or another registered entity. **(2) Responsibility** – A contract market or derivatives transaction execution facility that delegates a function under paragraph (1) shall remain responsible for carrying out the function.	Overview. Regulatory Chart. RSA. Market Supervision Trading Business Procedures. General Services Agreement with Eurex Frankfurt AG. Service Level Agreement with Deutsche Boerse AG. Clearing Services Agreement. Responses to CFTC Staff Questions (submitted November 4, 2003). USFE Letter to the Commission dated November 18, 2003. Responses to CFTC Staff Questions (submitted December 5, 2003).	Acceptable The USFE has not delegated any relevant function. Trade practice surveillance, market surveillance, and financial and sales practice surveillance will be contracted out to the NFA. The USFE staff will perform market supervision and real-time monitoring with a backup capability provided by Eurex Frankfurt AG. Clearing services will be contracted out to C Corp. The USFE would remain responsible for compliance with designation criteria and core principles for which relevant functions would be contracted out.
SEC. 5c(c) NEW CONTRACTS, NEW RULES, AND RULE AMENDMENTS – **(1) In General** – Subject to paragraph (2), a registered entity may elect to list for trading or accept for clearing any new contract or other instrument, or may elect to approve and implement any new rule or rule amendment, by providing to the Commission (and the Secretary of the Treasury, in case of a contract for sale of a government security for future delivery [or an option on such a contract] or a rule or rule amendment specifically related to such a contract) a written certification that the new contract or instrument or clearing of the new contract or instrument, new rule, or rule amendment complies with this Act (including regulations under this Act). **(2) Prior Approval** – **(A) In General** – A registered entity may request that the Commission grant prior approval to any new contract or other instrument, new rule, or rule amendment.	USFE Bylaws Articles I-X and XII and USFE Rules Parts 1-8.	Acceptable The USFE has requested that the Commission approve its proposed rules, which include its Bylaws, Articles I-XII and USFE Rules, Parts 1-8. Commission staff recommends such approval pursuant to Section 5c(c)(2) of the Act, since the USFE's proposed bylaws and rules do not violate any provision of the Act or the Commission's regulations. The letter from the Commission's Secretary apprising the USFE that it has been designated a contract market and that the Commission has approved its bylaws and rules should note that any change in the identity of the regulatory service providers or the regulatory services they provide to the Exchange are considered rule changes, and should be submitted as such, pursuant to Section 5c(c) of the Act and Part 40 of the Commission's regulations.
Core Principle 1 *In General* – To maintain the designation of a board of trade as a contract market, the	USFE submissions dated September 16, 2003 through January 30, 2004, that include the USFE Overview,	Acceptable

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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.	Regulatory Chart, Certificate of Formation, Bylaws, Amended and Restated Limited Liability Company Agreement, Rulebook, Membership Applications and Agreement, RSA, RCA, Market Supervision Trading Business Procedures, General Services Agreement with Eurex Frankfurt AG, Service Level Agreement with Deutsche Boerse AG, Clearing Services Agreement, Disaster Recovery Plan, User Guide, Response to CFTC Technical Questionnaire, Information Manual and System Overview, Operations Manual, Front End Installation Guide, Front End Operations Guide, Internal Trading Manual, Security Manual, Security Coordinator Manual, USFE Responses to CFTC Staff Questions (submitted November 4, 2003), USFE Letter to the Commission dated November 18, 2003, and USFE Responses to CFTC Staff Questions (submitted December 5, 2003, January 20, 2004, and January 23, 2004).	
Core Principle 2 *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.	Overview. Regulatory Chart. RSA, Schedule A (Scope of Regulatory Services). USFE Rules 203 (Disciplinary Committee); 205 (Compliance Department); Part 3 (Membership); Part 4 (Trading); Part 6 (Disciplinary Proceedings). Responses to CFTC Staff Questions (submitted November 4, 2003). USFE Letter to the Commission dated November 18, 2003. Responses to CFTC Staff Questions (submitted December 5, 2003).	Acceptable. The USFE has contracted with NFA to operate its trade practice surveillance and disciplinary programs. The NFA has performed similar functions for Merchants Exchange and the BTEX. Exchange staff will perform market supervision and real-time monitoring to include, among other things, real time surveillance of the market with respect to cancellation of trades, mistrade alerts, trading suspensions, switching from normal to fast markets and back, and maintenance of the proper operation of the Trading System, including oversight of market opening procedures, checking for validity of orders entered into the Trading System, and appropriate editing of information during the post-trading phase. The NFA has established procedures to detect violations and various trading abuses, including the ability to monitor for price manipulations and to monitor large trader positions, deliverables supplies, and futures and cash prices. The NFA has sufficient staff and resources, including its automated surveillance system and software for monitoring to detect and investigate potential rule violations. In this regard, the NFA has established procedures for regularly reviewing exception reports and

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		utilizing user profiles. The USFE Trading System will automatically create a full and accurate record of all bids and orders entered into the system, all matched transactions, and all entries into the Trading System, including orders that do not result in executions. The USFE will maintain its records of all entries in the Trading System for five years. The Trading System will transfer audit trail information to a secure and safe database. The NFA will have real-time view access to the USFE's trading screens and will receive trade data for surveillance purposes on a T+1 basis. The USFE and the NFA have established appropriate procedures to promote the fairness of investigations and ensure appropriate, thorough, and timely investigative analysis. The USFE and the NFA also have established acceptable procedures, clear and fair standards, and reasonable timelines for both summary and non-summary disciplinary actions. Staff recommends, however, that the Commission remind the USFE of its continuing obligation to devote sufficient resources to the enforcement of its rules, whether through outsourcing to the NFA or otherwise.
Core Principle 3 *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.	Overview p. 5.	Acceptable. The USFE did not submit any futures or option contracts with its application for contract market designation. The USFE intends to submit, under self-certification procedures, contract terms and conditions after it has been designated as a contract market. Consistent with the Act and regulations, Commission staff will conduct due diligence reviews once contracts are submitted.
Core Principle 4 *Monitoring of Trading* – The board of trade shall monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.	Overview p. 4. Regulatory Chart. RSA Schedule A (provides for monitoring of large trader positions, deliverable supplies, and cash and futures prices). Responses to CFTC Staff Questions (submitted November 4, 2003). USFE Letter to the Commission dated November 18, 2003. Responses to CFTC Staff Questions (submitted December 5, 2003). USFE Rule 205 (Compliance Department).	Acceptable. The USFE has contracted with the NFA to provide trade practice and market surveillance functions. The NFA will have real-time view access to the USFE's trading screens and will receive trade data for surveillance purposes on a T+1 basis. The NFA has established procedures to monitor trading for price manipulations and to monitor large trader positions, deliverables supplies,

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		and futures and cash prices. Exchange staff will perform market supervision and real-time monitoring. The surveillance procedures outlined in the USFE's submission, including the RSA, should minimize the potential for manipulation, distortion of prices, or disruption of delivery. Consistent with the Act and regulations, Commission staff will conduct appropriate review once position limits are submitted.
Core Principle 5 *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.	USFE Rules 412 (provides authority for establishment of Exchange position limits, and aggregation of positions); 414 (provides authority for establishment of Exchange position accountability, and aggregation of positions); 413 (provides authority for establishment of exemptions to position limits).	Acceptable Position limits or position accountability provisions would be established in the rules and contract specifications of the USFE futures and options contracts. Those contracts are not included in the USFE's application for designation as a contract market. The Commission should remind the Exchange that position limits or position accountability procedures must be specified for futures contracts listed by the Exchange. Position limits or position accountability procedures should be included with the Exchange's filing to the Commission in connection with the listing of each futures contract submitted under the Commission's certification or approval procedures.
Core Principle 6 *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.	USFE Bylaws Section 5.1 (Directors – Duties, Powers and Eligibility). USFE Rules 804 (Emergency Powers); 207 (Restrictions on Directors, Officers, Committee Members, Employees and Consultants). Responses to CFTC Staff Questions (submitted November 4, 2003). Responses to CFTC Staff Questions (submitted January 20, 2004).	Acceptable The CEO (or his or her designee) may take emergency action if the CEO determines that an occurrence or circumstance, including a circumstance that could have a severe, adverse impact upon the physical functions of the Exchange, constitutes an emergency that requires immediate action because it threatens fair and orderly trading in any contract, or the liquidation of or delivery pursuant to any contract. Among other actions, the CEO could order the liquidation or transfer of open positions, suspend or curtail trading, change delivery terms or conditions, and impose or modify price limits. The CEO must document the decision-making process and the reasons for taking emergency action and must notify the Commission of the exercise of emergency authority as soon as practicable. Notice would be provided by telephone, electronic mail, fax, or an equally

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		expeditious form of communication
Core Principle 7 *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.	Regulatory Chart p. 9. User Guide p. 138-141. Responses to CFTC Staff Questions (submitted November 4, 2003).	Acceptable. The USFE represents that it would post on its website the USFE Bylaws, Rules, and contract specifications, including the terms and conditions of all Exchange contracts and the mechanisms for executing transactions on or through the Trading System. The USFE further represents that it would post on its website and/or provide written notice to its members of the listing of new products or changes to its Rules, Bylaws or contract specifications. The Trading System includes a market supervision message window that allows the Exchange to readily disseminate to all Trading System participants messages announcing significant events such as the addition of new contracts or changes in the terms of existing contracts.
Core Principle 8 *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.	Regulatory Chart p. 9.	Acceptable. Daily information on settlement prices, volume, open interest, and daily opening and closing prices for actively traded contracts would be posted on the Exchange's website and made publicly available through various price reporting providers.
Core Principle 9 *Execution of Transactions* – The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions.	USFE Rules 404 (Execution of Transactions); 415 (authorizes block trades); 416 (authorizes EFPs); 417 (authorizes EFSs); 418 (authorizes Vola trades). Responses to CFTC Staff Questions (submitted November 4, 2003). USFE Letter to the Commission dated November 18, 2003. Response to CFTC Technical Questionnaire. User Guide. Information Manual and System Overview. Operations Manual. Front End Installation Guide. Internal Trading Manual. Security Manual. Security Coordinator/Master Terminal Operator Manual. Disaster Tolerance Concept for Exchange Trading Systems Operated by Deutsche Boerse Systems.	Acceptable On-centralized market trading: Orders entered into the Trading System would be executed in accordance with either a price time priority algorithm or a price pro-rata algorithm as determined by the USFE on a contract-by-contract basis. The price time priority algorithm gives first priority to orders at the best prices, and then gives priority among orders at the same price based on time of entry into the Trading System. The price pro-rata algorithm assigns first priority on the basis of price and fills orders at the same price on a pro-rata basis. These algorithms are similar to those previously approved by the Commission for other electronic trading systems. Off-centralized market trading: The block trading rule at the USFE is similar to the block trading rules approved at

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		other electronic trading systems. Block trades may only be effected through the USFE's electronic Block Trade Facility and only in contracts authorized for that purpose. A member must be an Eligible Contract Participant (ECP) to arrange block trades on the USFE system. When a member enters into a block trade on behalf of a customer, the customer also must either be an ECP or be advised in connection with the block trade by a person that meets certain asset management and registration criteria. The transaction may be consummated at a price mutually agreed upon by the parties to the transaction, provided that the price for the futures contract is no more than five ticks outside of the range of the day's high and low at the time of the transaction. Immediately upon agreeing to enter into the block trade transaction, the buyer must enter the details of the trade on the screen. Within 15 minutes thereafter, the seller would execute the block trade by confirming the details of the transaction. Upon confirmation, the Exchange would immediately update the online time and sales report to reflect the transaction. The USFE has not submitted minimum block transaction size thresholds because no specific futures contracts have been submitted with its Contract Market Application. The USFE intends to submit contract terms and conditions after it has been designated as a contract market. The EFP and EFS trading rules at the USFE are similar to the EFP and EFS rules approved at other electronic trading systems. The Vola Trading Facility is discussed in Section VI below. Information technology issues: The USFE has provided extensive documentation regarding their system and its operation, both during this review period and during previous periods in which the Commission has acquired relevant technical information. That documentation includes system architecture diagrams and descriptions, system design specifications, security policies and procedures, system development life cycle management plans, quality control policies and procedures, capacity planning guidelines, and disaster recovery plans. The USFE system has no single point of failure within the

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		network. The loss of equipment or a site results in automatic reconfiguration and load balancing within 15 to 60 seconds. In the event of a failure, database consistency is assured through rollback of incomplete transactions and in-flight transactions are automatically retransmitted after recovery. The USFE's private network environment enables the Exchange to achieve nearly uniform message delivery times, thereby ensuring equal access for all participants. The USFE system provides extensive security controls to safeguard the system and its trade information. All traffic is encrypted by the application software, using a 64-bit random value. Only workstations with correct, pre-assigned IP addresses, that are recorded and enforced by the Member Integration System Server (MISS), may communicate with the Wide Area Network (WAN) to reach the host. Only workstations that are assigned to a specific MISS, as enforced by matched passwords embedded in the application software and unique per MISS, may communicate with the WAN. The combination of these controls provides a highly secure hardware environment. Controls at the user level include user id/password pairs that are assigned to each user by a member's security officer and the ability of the system to allow a user only to perform functions for which he has been authorized. During a site visit on December 10, 2003 to the USFE's primary and backup data centers and operations areas, Commission IT staff were able to observe first-hand the trading system and its supporting infrastructure, the staff and operational control facilities supporting the operation, and the physical security and environmental controls provided by the USFE facilities. The documentation provided by the USFE indicates, and the demonstration of the USFE Trading System verified, that the USFE provides for open, competitive and efficient trading on the USFE trading facility.
Core Principle 10 *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	Overview p. 3. USFE Rules 307 (Duties of Members); 308 (Prohibited Conduct); Part 4 (Trading); 803 (Confidentiality of Information). Regulatory Chart p.10. RSA – Membership Agreement – Market Supervision	Acceptable. The USFE has contracted with the NFA to operate its trade practice surveillance program. The NFA has

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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.	RSA. Membership Agreement. Market Supervision Trading Business Procedures. User Guide. Response to CFTC Technical Questionnaire. General Services Agreement with Eurex Frankfurt AG. Responses to CFTC Staff Questions (submitted November 4, 2003). USFE Letter to the Commission dated November 18, 2003.	established procedures for the detection and investigation of trading abuses. Orders submitted to the Trading System must specify, among other things, buy or sell, contract identification, quantity, price (limit orders), expiration of order, CTI code, and customer account number. In addition to a Trader ID, the Trading System captures and associates with each order an identifier for each individual workstation through which an order can be entered and, thus, it is possible to identify the workstation from which the request came and the individual trader who initialized the request. A bunched order must include the entry of an indicator that it is a bunched order. If a terminal operator receives an order that cannot immediately be entered into the Trading System, a written order that includes the order instructions, account designation, and date and time of receipt must be prepared. The USFE's Trading System will automatically capture all details of each trade in a comprehensive electronic audit trail, including the time of entry of each bid or offer and the time of execution. All activity and messaging within the Trading System will be recorded in a secure and complete record that Members cannot edit. Audit trail data will be maintained on-line for 13-25 months, and stored off-line in a readily accessible, machine-readable format for five years. The NFA's automated surveillance system will enable the NFA to reconstruct the USFE transactions and to create user profiles. The NFA will have real-time access to the USFE's supervisory screens and will receive data on a T+1 basis.
Core Principle 11 *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.	RSA, Attachment A. Clearing Services Agreement. USFE Rules 101 (Definition of Clearing Member); 302 (Eligibility for Membership); 307 (Duties of Members); 314 (Termination of Membership); 503 (Clearance Authorization); 611 (Penalties Imposed as a Result of Disciplinary Proceedings). Responses to CFTC Staff Questions (submitted January 23, 2004). C Corp Rules 201 (Qualification of Members); 204 (Financial Statements of Members); 207 (Notices	Acceptable The USFE has entered into an agreement with C Corp to provide clearing and settlement and other services for the Exchange. The USFE has also entered into a Regulatory Services Agreement with NFA, and Attachment A thereto lists the tasks NFA will perform for the USFE, including analysis of the financial information of applicants, review of periodic financial statements of members and ongoing and daily financial surveillance. *See* entry at Designation

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	Required of Members); 301 (Effect of Clearance).	Criterion 5. USFE Rule 314 states that the membership of any person may be terminated at any time if the USFE determines that such member no longer meets any one or more of the eligibility standards set forth in Rule 302, including minimum financial standards. USFE Rule 611 authorizes a hearing panel of the USFE Disciplinary Committee to impose any one or more of various penalties, including a fine, limitations on positions that a member may carry or hold, suspension of trading privileges, denial of future access to any of the USFE markets, suspension as a member or clearing member, or termination as a clearing member or member. C Corp Rule 203 states that the failure of any clearing member to comply with C Corp Rules and Bylaws, including any financial standards applicable to membership, may subject a clearing member to a suspension or revocation of clearing privileges. Pursuant to this rule, C Corp also may: (a) impose additional capital, margin or other requirements upon the clearing member; (b) allow such clearing member to submit trades solely for the member's own account; (c) allow such clearing member to submit trades for liquidation only; (d) limit or restrict the type of contracts that may be cleared by such member in any of its accounts with the C Corp; or (e) limit or restrict the number of contracts that are permitted to be maintained by such member in any of its accounts with the C Corp. The USFE has become a member of the Joint Audit Committee, but (as set forth below) will be contracting for financial surveillance services from NFA and C Corp. The USFE has entered into agreements with the NFA and C Corp to, among other things, assist it in carrying out financial surveillance. NFA staff will review the financial information of applicants, and conduct risk analysis interviews to obtain understanding of applicant firms' operations, trading activity, types of customers, etc., and will assess firms' risk management practices. NFA staff will review periodic financial statements of USFE members, and the same staff will conduct on-going daily risk analysis of members' positions and SHAMIS settlement and margin deficit information (SHAMIS is a system, developed and operated by C Corp, for clearing

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		organizations to share pay and collect information concerning common members). C Corp will perform daily and intra-day financial surveillance of clearing members, and will maintain its Net Debit Cap system to provide intra-day pay/collect and drill-down information by firm and origin, and provide e-mail alerts for unusual situations, information which will also go to NFA. For those USFE members for which NFA is DSRO, NFA will perform audits in accordance with CFTC rules and interpretations 4-1 and 4-2.
Core Principle 12 *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.	USFE Rules 307 (Duties of Members); 307(d) (requires keeping records showing details and terms of all transactions); 307(m) (requires diligence in receiving and handling customer orders); 307(n) (requires maintaining internal rules, procedures and controls to assure priority of customer orders); 308 (details prohibited conduct for members, including disseminating false information, manipulating prices, entering orders other than in good faith, non-competitive trading, or conduct inconsistent with just and equitable principles of trade, and requires members to comply with the Act and Commission regulations, as well as the bylaws, rules and procedures of the Exchange and C Corp); 309 (requires members to comply with requirements of contracted entity performing market, trade practice, financial and sales practice surveillance and investigations and disciplinary procedures); 403 (sets out detailed procedures and safeguards for entering orders into the Trading System). Bylaw Section 9.11 (Restrictions on Trading and Disclosure by Employees). RSA. Membership Application and Agreement. Responses to CFTC Staff Questions (submitted November 4, 2003).	Acceptable. The USFE has contracted with the NFA to assist in carrying out self-regulatory responsibilities with respect to trade practice surveillance. The USFE will use an automated system to provide such surveillance. The NFA would monitor for, among other things, trading ahead of customers (direct and indirect), front running, direct and indirect crossing, taking the other side (direct and indirect), prearranged trading, wash trading, money passing (direct and indirect), counterparty trade percentages, stop order fishing, marking the close, error account and transfer trade activity and off-exchange transactions.
Core Principle 13 *Dispute Resolution* – The board of trade shall establish and enforce rules regarding [sic] and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries.	USFE Rules Part 7 (Customer Disputes). RSA.	Acceptable The USFE has contracted with the NFA to offer its arbitration forum for the resolution of customer vs. member disputes and member vs. member disputes. Pursuant to USFE Rule 701, a customer vs. member dispute would be resolved pursuant to the NFA arbitration rules. If the customer is an ECP, the parties may agree to use the arbitration facilities of another SRO. If the customer is not an ECP, submission of the dispute

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		to arbitration is voluntary. Failure by any Member to comply with any decision issued by the NFA or other SRO in resolving a dispute constitutes a violation of the USFE's rules.
Core Principle 14 *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 paragraph).	USFE Bylaws Sections 5.1(e) (provides that a Director must be at least 18 and not be ineligible to serve); 5.3(d) (Director who becomes ineligible would be removed from Board); 5.6 (Eligibility for Service on Boards and Committees). Rules 302(a) (eligibility to become a member); 304(a) (standards for denial of membership); 307(b) (requires that members notify the Exchange upon becoming aware of certain events). Regulatory Chart p. 11. RSA. Responses to CFTC Staff Questions (submitted November 4, 2003). Responses to CFTC Staff Questions (submitted December 5, 2003). Responses to CFTC Staff Questions (submitted January 20, 2004).	Acceptable Members that are individuals must be adults of good character. Members that are entities must be duly organized, existing and in good standing under the laws of the jurisdiction in which they are organized. An applicant must have good commercial standing and appropriate business experience, adequate financial resources, and operational capabilities for the type and level of business it intends to conduct. Where relevant, an applicant shall be licensed, registered or otherwise permitted by the appropriate governmental authority to conduct business on the USFE and meet any other criteria it prescribes. An applicant may be denied membership if, among other similar reasons, the applicant: has been convicted of any felony or misdemeanor involving, or is enjoined from engaging in any practice related to, the purchase or sale of commodities, futures, options, securities, or other financial instruments, or involving moral turpitude; has been sanctioned or censured by any governmental agency; or has been suspended or disciplined by any SRO. Thereafter, a member must abide by the USFE's Bylaws and Rules as well as the provisions of the Act and Commission regulations. A member must file reports with the USFE disclosing events that reflect on his or her suitability to continue as a member, including reports of disciplinary actions by governmental or self-regulatory entities. Bylaw Section 5.6 generally follows the standards set out in Commission Regulation 1.63(c).
Core Principle 15 *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.	USFE Bylaws Sections 5.7 (Improper Use or Disclosure of Material, Non-Public Information); 9.8 (Restrictions on Trading and Disclosure by Employees). Rule 207 (Restrictions on Directors, Officers, Committee Members, Employees and Consultants). Regulatory Chart p. 12. Responses to CFTC Staff Questions (submitted November 4, 2003). Responses to CFTC Staff Questions (submitted January 20, 2004).	Acceptable. The USFE prohibits any Board member or member of a Committee of the Exchange from knowingly participating in the deliberation or voting on a matter if the member is the named-party in interest, has a specified relationship with a named-party in interest, or has a substantial financial interest in the matter. The USFE requires those

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	Questions (submitted January 20, 2004).	members to disclose any such conflicts of interests. A member may participate in the deliberation, but not vote, on a matter in which the member has a substantial financial interest if the member's presence is necessary for a quorum or the member possesses unique expertise. No Board or Committee member may use or disclose material, non-public information obtained during the member's participation on the Board or a Committee other than in the performance of his or her duties as such member. A USFE employee or consultant may not use or disclose material, non-public information obtained in the performance of his or her duties for any purposes inconsistent with such performance. A USFE Board member, Committee member, employee or consultant may not trade any commodity interest for such person's own account, or on behalf of any other account, on the basis of any material, non-public information. In addition, any officer, Director, or employee of any corporate affiliate of the Exchange providing any services to the USFE will be bound by the insider trading prohibitions of Rule 207 and may not trade any commodity interest on the basis of material, non-public information obtained through the performance of such person's official duties or use or disclose material, non-public information obtained in the performance of his or her duties for any purposes inconsistent with such performance. Such persons include directors, officers and employees of Eurex, Deutsche-Boerse AG, SWX and other European affiliates of the USFE. The Exchange will obtain commitments from any employees of the USFE's affiliates providing regulatory services (*i.e.*, market supervision in a backup capacity) that such employees will: (1) abide by Commission Regulation 1.59 and USFE Rule 207 and not trade on inside information; (2) consent to Commission jurisdiction to enforce that commitment; and (3) agree that USFE may accept service of communications from the CFTC on their behalf with respect to that commitment.

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Core Principle 16 *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.	Bylaw Section 3.3 (Admission of Shareholders); Article V (Directors). Responses to CFTC Staff Questions (submitted November 4, 2003). Responses to CFTC Staff Questions (submitted December 5, 2003). Responses to CFTC Staff Questions (submitted January 20, 2004).	Acceptable. The USFE will not be mutually owned. The USFE Board would have 12 Directors. Six of the Directors would be elected by the Class A shareholders (USEH) and three of the Directors would be elected by the Class B shareholders (EPH). The other three Board members would be Public Directors, who would represent arbitrage firms, institutional investors, and independent clearers, with one Director representing each group. These three Directors would be selected by the Class A shareholders from a group of five nominees for each of the three positions selected by the Class B shareholders. The USFE has stated that the composition of the Board "will be balanced, representing all segments of Exchange participants."
Core Principle 17 *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.	Regulatory Chart p. 13. RSA. Response to CFTC Technical Questionnaire. Responses to CFTC Staff Questions (submitted November 4, 2003). USFE Rules 307 (Duties of Members); 307(d) (requires that members retain Commission-required records); 307(c) (requires that members make and file reports in accordance with Commission Regulations); 308(a) (prohibits members from violating or failing to conform to applicable provisions of the Act, Commission regulations, or any other law applicable to the USFE).	Acceptable. The USFE and those providing services to the USFE relating to core regulatory functions and exchange operations for the USFE will maintain records in accordance with Commission Regulation 1.31. The USFE's Trading System would automatically create a full and accurate record of all entries into the system, including all bids, offers and orders, and all matched transactions, allowing for a comprehensive audit trail. All activity and messaging within the Trading System will be recorded in a secure and complete record. Audit trail data will be maintained on-line for 13 to 25 months, and stored off-line in a readily accessible, machine-readable format for five years and can be accessed within 24 hours.
Core Principle 18 *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 anticompetitive burden on trading on the contract market.	Agreement and Bylaws. Rules. Regulatory Chart.	Acceptable The USFE's Trading System will be fully anonymous from order entry to clearing. It will make no distinction in the order execution of members and customers. All members will have access to the same order book and the ten best bid/ask prices. Members do not have special access to trade information, and no member has an informational advantage over any other member arising

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		from the trading platform. Trades will be matched using either a price/time priority algorithm or a price pro-rata algorithm as determined by the USFE on a contract-by-contract basis. The USFE's off-order book functionalities are consistent with the rules and practices of other U.S. exchanges. *See* Section VII below for discussions of the following: fair competition; the possibility that Eurex would abuse or leverage monopoly power in its own market; and payment for order flow and non-competitive pricing. *See* Section VI below for a discussion of the USFE/BTEX revenue commission agreement and the antitrust implications thereof.

IV. Noteworthy or Novel Issues

A. Ownership of the USFE

The USFE and the two entities that own it, the USEH and the EPH, are all U.S. entities. The USEH holds an 80% interest in the USFE and the EPH has a 20% stake.[15] Because the USEH is wholly owned by foreign entities, 80% of the USFE is indirectly owned by foreign entities. Neither the Act nor the Commission's regulations establish any prohibition against or special criteria concerning foreign ownership of contract markets. Accordingly, staff has analyzed the USFE's application, and its compliance with the designation criteria and core principles, in the same manner in which it would analyze the application of any contract market applicant, whether foreign or domestically owned.

Staff points out that majority foreign ownership of the USFE, while noteworthy, is not unique to this application. The NQLX Futures Exchange (NQLX) has had a significant level of foreign ownership since it was designated in 2001. At the time of its designation, NQLX was operating as a joint venture of the NASDAQ Stock Market and The London International Financial Futures and Options Exchange (LIFFE). Since July 2003, NQLX has been owned entirely by LIFFE. Foreign ownership of NQLX has not been an obstacle to either NQLX's ability to comply with the Commission's contract market requirements or the Commission's ability to monitor and enforce that compliance.

Of course, the simple determination of whether a contract market is "foreign-owned" is not so straightforward. For instance, demutualized exchanges may have a significant number of,

[15] *See* footnotes 2 and 3 for a description of the chain of ownership for the USFE and the USEH. The USFE Corporate Affiliation Chart can be found above in Section III.

or even become controlled by, foreign shareholders.[16] The concept of foreign ownership is additionally complicated by the fact that equity in an exchange can be held by owners in a wide number of jurisdictions, without a majority of ownership in any single jurisdiction. If "foreign" ownership is premised on where a majority of ownership interest is located, such an exchange would be considered foreign-owned in all jurisdictions (and domestically-owned in none). This definitional problem alone argues against the Commission applying some special prohibition or restriction based solely or primarily upon the foreign-owned status of a contract market.

The USFE itself is a U.S. limited liability company, formed in Delaware and headquartered in Chicago, Illinois. If designated, it would be subject to the same statutory and regulatory provisions as any other DCM. As reflected throughout this memorandum, Commission staff has analyzed the USFE's indirect foreign ownership and involvement with its foreign affiliates. Staff's analysis, however, focuses on how those relationships would bear upon the ability of the Exchange to comply with the designation criteria and core principles and the ability of the Commission to oversee and enforce that compliance. This approach does not differ in any way from the manner in which the Commission has previously reviewed analogous situations at other contract markets (*e.g.*, the handling of market supervision for the CBOT a/c/e trading by Eurex employees in Frankfurt, Germany, and the location of Merchants' Exchange's trade-matching engine in Canada).

The Act and implementing Commission regulations require the Commission to consider applications for designation as a contract market based upon compliance with the eight designation criteria and 18 core principles. There is no legal basis for the Commission to discriminate between domestic and foreign-owned entities. Establishing any barrier to entry on

[16] Similarly, several mutually-owned U.S. futures exchanges have had foreign members who owned seats and had full voting privileges in exchange elections.

the basis of foreign ownership alone would stifle innovation and a potential source of competition for existing contract markets.

B. Revenue Commission Agreements

As noted above, the Exchange is owned by two entities: the USEH (80% equity) and the EPH (20% equity). This recent change in the ownership structure of the Exchange occurred through the USFE's acquisition of the BTEX, announced on January 15, 2004.[17] As a result of that transaction, the USFE acquired the assets of the BTEX, consisting primarily of the BTEX's DCM license and the BTEX staff. The BTEX license will be held indirectly by the USFE, through a wholly-owned subsidiary created to merge with the BTEX, and will not be used for trading. In addition, as part of the acquisition, seven firms entered into separate RCAs with the USFE. The RCAs, which are discussed in more detail below, obligate the seven firms to prepay trading fees to the Exchange that are creditable towards U.S. Treasury complex futures and option transactions. The RCAs have non-renewable terms of 36 months and collectively obligate the firms to pay approximately $18 million in prepaid trading fees. In return for these considerations, the EPH received a 20% equity stake in the USFE, the right to appoint three of the USFE Board's 12 directors, and the right to nominate, but not select, the Board's three public directors.

Additional information concerning the restructuring of the BTEX, the operation of the RCAs, and the trading incentives and antitrust implications of the RCAs, is set forth below.

1. Restructuring of the BTEX and its Acquisition by the USFE

The BTEX was restructured in connection with its acquisition by the USFE. Pursuant to this restructuring, all the BTEX shareholders transferred their ownership interest in the BTEX to

[17] *See* Eurex Press Release, "Eurex US Partners With 17 U.S. Financial Institutions," January 15, 2004. (http://www.eurexchange.com).

the EPH, leaving the EPH as the BTEX's sole shareholder. In consideration for the transfer of sole ownership to the EPH, all former direct and indirect BTEX equity shareholders received an ownership interest in the EPH itself.

Upon the merger of the USFE's wholly-owned subsidiary with the BTEX, all the BTEX shares held by the EPH were cancelled and converted into the USFE Class B shares, representing a 20% equity stake in the USFE. The USFE Class A shares, representing the remaining 80% of equity, is held by the USEH. With the merger, the BTEX is now a wholly-owned subsidiary of the USFE. The former direct and indirect equity shareholders of the BTEX, along with an RCA Participant who had no prior equity interest in the BTEX, through their collective ownership interest in the EPH, hold a 20% equity stake in the USFE.

2. Operation of the RCAs

As part of the overall restructuring of the BTEX, seven partners of the EPH (RCA Participants, Participants or RCA Firms) and the USFE have agreed to enter into separate, identical RCAs.[18] The RCAs would run for a maximum of three years. If not terminated early, over the three-year life of the RCAs, the total of prepaid fees provided by Participants would equal about $18 million. The prepaid fees would be creditable against a Participant's proprietary transactions and certain types of non-discretionary customer transactions.

3. RCA Trading Incentives

Staff is aware of concerns that the RCAs may create incentives for RCA Participants to recommend that customers execute futures and option contracts on the USFE in possible violation of fiduciary obligations to customers or to engage in improper volume-pumping behavior, such as wash trading. As discussed below, staff has reviewed the regulatory measures

[18] The seven RCA Participants are Citigroup Global Markets, Inc., Deutsche Bank Securities, Inc., Goldman Sachs & Co., Lehman Brothers, Inc., Man Financial, Inc., Morgan Stanley & Co. Inc., and Refco LLC.

that the USFE would implement in connection with the implementation of the RCAs and believes that those measures should adequately protect both customers and the market from any such abuses. Staff discusses below the reasons for its belief that, while the RCAs may create incentives for RCA Participants to trade at the USFE, there are competing factors that should mitigate the effect of any such incentives.

a. Regulatory Review

Staff has reviewed the RCAs as it reviews all exchange programs that may create trading incentives. In this regard, DCMs have consistently offered reduced fees and other economic incentives to market makers, brokers and traders in order to attract volume to particular products.[19] Regulatory analysis of DCM-sponsored incentive programs focuses on the plan's potential for eroding fiduciary obligations owed by brokers to customers. Core Principle 12 requires DCMs to establish and enforce rules that protect market participants from abusive trading practices committed by any party acting as an agent for a participant, and in a situation where a broker handles an order that could be executed at more than one exchange, Commission staff seeks to ensure that an incentive plan does not compromise the broker's fiduciary obligations.

Staff also reviews the manner of implementation of each incentive plan and its potential for distorting open, competitive, and efficient trading by facilitating illegal trading practices. Staff reviews incentive programs with a view to determine whether such programs are structured in a way so as to encourage trade practice abuses, such as wash or fictitious trading. DCMs are

[19] *See*, e.g., CME Incentive Program for Agency Futures Trading (March of 2000); New York Mercantile Exchange (NYMEX) ClearPort Incentive Plan (February 17, 2003); CME Euro FX and Euro FX Cross-Rate Incentive Program (April of 1999); CBOT Modified Market Maker Program for the Wilshire Small Cap Index Futures Contract (June 18, 1993); CME Principal Market Maker Program (April 20, 1995); NYMEX Specialist Market Maker Program (July 8, 1998); CBOT a/c/e Temporary Fee Waiver Program Extension (March 25, 2003).

obligated by Core Principle 2 to monitor trading for trade practice abuses.[20] Under Core Principle 9, DCMs must also provide a market that is open, competitive and efficient. In this regard, an acceptable incentive program must be based upon an exchange's ability to monitor and detect trade practice violations, and to maintain an open, competitive and efficient marketplace.

b. Competing Incentives

The seven RCA Participants have significant investments at both the USFE and the CBOT and thus appear to have a mixed set of incentives as to where to recommend that customers execute Treasury futures and option contracts. Each of the seven RCA Participants is also a CBOT clearing firm. Like all CBOT firms clearing customer trades, each RCA Participant owns at least two full seats. As of January 22, 2004, a full seat at the CBOT was worth $510,000, resulting in each RCA Participant currently having a minimum investment in the CBOT of slightly more than $1 million. Notably, one RCA Participant owns eight full seats at the CBOT and 12 more restricted seats with a current total market value of $5.6 million and, in total, the seven RCA Participants own CBOT seats valued at $25.6 million. If the CBOT loses its Treasury products business to the USFE (a business that accounted for 78% of the CBOT's total volume last year), the value of these CBOT seats could decline dramatically and, consequently, the seven RCA Participants could suffer significant capital losses in connection with their CBOT holdings. If the USFE is successful, as a result of either capturing trading volume from the CBOT or by other means, the value of the RCA Participants' USFE holdings would likely increase. However, any gain in the value of the RCA Participants' USFE holdings would likely be at the cost of the value of their seats at the CBOT. Thus, the RCA Participants'

[20] The Acceptable Practice to Core Principle 2 in Part 38 of the Commission's regulations makes clear that DCMs should maintain a trade practice surveillance program that uses "electronic analysis of [trading] data routinely to detect potential trading violations."

investment in the USFE may actually operate as a hedge against the potential loss in value of CBOT seats should the USFE be successful.

Although RCA Participants would have mixed incentives as to where to recommend that customers execute Treasury futures and option contracts, staff notes that firms that are not RCA Participants, but that are CBOT members, would have the strongest motivation to recommend that customers execute such contracts on the CBOT rather than the USFE. While these CBOT members may become USFE members to retain their customers, as non-RCA Participants they will not have any equity interest in the USFE. With no equity stake in the USFE, but a continuing equity stake in the CBOT, the strongest motivation for these firms will be to promote the value of their CBOT seats by executing orders at that exchange, rather than the USFE.

c. Protections

While RCAs are unlike the standard incentive programs previously reviewed by the Commission at other exchanges, like those programs, RCAs would create some clear incentives for RCA Participants to trade at the USFE. Accordingly, staff has reviewed the USFE's rules and procedures to determine whether they minimize the potential that the trading incentives of the RCA could result in harm to customers or to the markets. In this regard, the USFE has adopted rules and procedures as follows:

- USFE Rule 315 would require each RCA Participant to:
    - provide written disclosures to customers of the RCA Participant and its affiliates describing the RCA Participant's financial interest in the USFE;
    - retain for a five-year period records substantiating the non-discretionary status of customer orders;
    - retain for a five-year period written records establishing a customer's account and the parameters for routing of customer orders;
    - in the absence of documents establishing such parameters, retain for a five-year period any required records of customer orders specifying the exchange designated by the customer on which the order is to be executed; and

- provide the USFE with aggregate data regarding transactions for which the RCA Participant is claiming a credit against fees previously paid and the number of orders that were transmitted by an automated order routing functionality supplied by the RCA Participant.

- The USFE will ensure that the NFA, as the USFE's regulatory services provider, has the necessary information to identify transactions that have been effected by an RCA Participant or its affiliates and the time periods during which the USFE transaction volume could have a material economic consequence for the RCA Participant under the terms of the RCA in order to enable the NFA to more closely focus its compliance procedures to monitor for wash trading and any other illegal activity by RCA Participants and their affiliates during those periods.
- The USFE or the NFA will conduct periodic audits of each RCA Participant's compliance with its obligation under the RCA to identify customer transactions as to which the RCA Participant exercises discretion regarding the exchange on which the order is to be executed.

Staff views the above USFE rules and procedures, including the required disclosures to customers and audits of trading at RCA Participants, as adequate to detect and deter any illegal activity that might result from the trading incentives that may be created by the RCAs.

4. Antitrust Analysis

Section 15(b) of the Act requires that the Commission, in issuing any order, take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives, policies and purposes of the Act. In addition, Core Principle 18 mandates that a board of trade endeavor to avoid adopting any rules or taking any actions that result in any unreasonable restraints of trade or impose any material anticompetitive burden on the contract market.[21] Accordingly, staff has evaluated the antitrust implications inherent in the RCAs resulting from the merger between the Exchange and the BTEX, and has concluded that the RCAs do not unreasonably restrain trade or otherwise unlawfully affect competition.

[21] 7 U.S.C. § 7(d)(18). The Commission has an obligation to assure continued compliance with this and other core principles, and may request a written demonstration that the contract market is in compliance with one or more core principles. 17 C.F.R. § 38.5(b).

The RCAs may be viewed in two ways. As discussed above, they could be viewed as an incentive program to encourage the Participants to trade on the Exchange. Alternatively, the RCAs collectively could be viewed as equivalent to a 3-year $18 million note for an equity stake in the Exchange. Thus, if the RCA Participants never used any of the prepaid trading fees, they would simply pay the Exchange $18 million as the primary consideration for the EPH's 20% equity stake.

Regardless of how they are viewed, RCAs and similar arrangements are not inherently unlawful under the federal antitrust laws;[22] they unreasonably restrain trade only where they foreclose a portion of the relevant market significant enough to injure competition, either by shutting out existing competitors or by creating a bar to entry by potential competitors. *See U.S. v. American Tobacco Co.,* 221 U.S. 106, 181 (1911); *Roland Machinery Co. v. Dresser Industries, Inc.,* 749 F.2d 380, 393 (7th Cir. 1984). In order to harm competition, the parties to the agreement must have substantial market power—that is, the ability to control prices or exclude competition—in the relevant market. *See, e.g., Eastman Kodak Co. v. Image Technical Services, Inc.,* 504 U.S. 451 (1992); *Jefferson Parish Hosp. Dist. No. 2 v. Hyde,* 466 U.S. 2 (1984). Accordingly, staff's examination of the potential antitrust issues presented by the RCAs began by identifying the relevant market.

Determining the relevant market requires an inquiry into two factors: (1) identifying the cluster of products or services with which the instant product or service competes (the "relevant product market"); and (2) identifying the geographic area in which the product or service

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[22] The U.S. Department of Justice did not object to a similar RCA of limited duration recently structured by BTEX and ICAP, observing that ". . .the RCAs will permit other interdealer brokers to compete for the business of the BrokerTec shareholders. . . .". *See* Department of Justice Press Release dated April 22, 2003; www.usdoj.gov/atr. Nor are these arrangements prohibited by the Act. Staff notes that DCMs traditionally have offered reduced fees and other economic incentives to market makers, brokers and traders in connection with the launch of a new product or market.

competes (the "relevant geographic market"). The extent to which the product at issue -- the provision of exchange services for U.S. Treasury futures -- is interchangeable in use with other, alternative products is a particular consideration in determining the relevant product market. *See Eastman Kodak, supra.; U.S. v. E.I. DuPont de Nemours & Co.,* 351 U.S. 377, 394-95 (1956). Staff believes that reasonable substitute financial instruments are not available to industry participants seeking the economic benefits that exchange-traded U.S. Treasury futures and options provide. Exchange-listed futures and option contracts are significantly different from contracts traded in other environments, such as over-the-counter (OTC) markets, because they provide anonymity, generally greater liquidity, a broader customer base, and important risk management benefits and tax advantages. Futures on U.S. Treasury securities currently are not traded on exchanges outside the U.S. For the most part, exchanges desiring to offer these instruments have been located in the U.S.[23] The U.S. regulatory framework provides protections, obligations and incentives that make exchange-traded futures a differentiated market. Accordingly, staff has concluded that (1) the provision of exchange services for U.S. Treasury futures and options in the U.S. is a relevant product market for purposes of the U.S. antitrust laws; and (2) because the USFE seeks to compete in the U.S., the U.S. is the relevant geographic market. *See, e.g., Bailey v. Allgas, Inc.,* 284 F.3d 1237, 1247-48 (11th Cir. 2002).

Once the relevant market is defined, an antitrust analysis focuses on whether the USFE possesses the degree of market power, and/or whether the RCA commitments represent a degree of market power, necessary to threaten competition.[24] At present, the CBOT is the dominant

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[23] While non-U.S. exchanges can trade, and have traded, U.S. Treasury futures contracts, tax, regulatory, and time zone considerations have provided a comparative advantage for the U.S. exchanges effectively limiting trading to U.S. exchanges.

[24] Market power may be shown by evidence of specific conduct indicating the seller's power to control prices or exclude competition, or it may be inferred from one seller's large percentage share of the relevant market and (continued)

U.S. DCM offering exchange services for U.S. Treasury futures. In 2003, its market share is estimated to have been in excess of 99 percent, and currently its market share is 100 percent.[25] The USFE, as a new entrant, has no market share and therefore has no market power in the relevant market.

The BTEX became a DCM on June 18, 2001. Its primary owners were large futures commission merchants (FCMs) and investment banking concerns. The BTEX listed and traded futures and option contracts on the U.S. Treasury debt complex. The BTEX futures and options contracts were identical to the CBOT U.S. Treasury debt complex futures and options contracts. For the period January to November 2003, the BTEX had an average monthly trading volume only of 123,348 contracts, or .51 percent of total transaction volume in futures contracts on U.S. Treasury securities.[26] The BTEX had an insignificant share of the U.S. Treasury futures and options market and, therefore, the acquisition of the BTEX by the USFE presents no market power concerns.

As noted above, the seven firms that have entered into the RCAs are large FCMs that are extremely active in the U.S. Treasury futures and option markets. Even if the RCA Participants collectively executed transactions to utilize all their RCA credits, such volume would be significantly less than 10 percent of the overall U.S. Treasury futures and options trading volume. Accordingly, staff has concluded that the USFE's acquisition of the BTEX and the

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significant barriers to entry. *Kodak, supra.* at 469; *Tops Markets, Inc. v. Quality Markets, Inc.,* 142 F.3d 90, 97-98 (2d Cir. 1998).

[25] The average monthly U.S. Treasury futures trading volume on the CBOT in 2003 was 24,037,074 contracts, or 99.5 per cent of total trades. *See* FIA, *Monthly Volume Report,* December 2003.

[26] *Id.* The BTEX ceased trading on November 26, 2003.

execution of the RCAs do not give USFE sufficient market power to adversely affect competition in U.S. Treasury futures and options.[27]

The purpose of an inquiry into market definition and market power is to determine whether an arrangement has the potential for genuine adverse effects on competition. *See FTC v. Indiana Fed'n of Dentists,* 476 U.S. 447, 460-61 (1986); *Toys "R" Us, Inc. v. FTC,* 221 F.3d 928, 937 (7th Cir. 2000). Even where firms hold monopoly power, however, courts have declined to penalize them for engaging in normal competitive behavior such as non-predatory development of new product features or expanded services that adversely affect competitors' products or services.

> The mere possession of monopoly power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system. The opportunity to charge monopoly prices -- at least for a short period -- is what attracts "business acumen" in the first place; it induces risk taking that produces innovation and economic growth. To safeguard the incentive to innovate, the possession of monopoly power will not be found unlawful unless it is accompanied by an element of anticompetitive *conduct.*

Verizon Communications, Inc. v. Law Offices of Curtis V. Trinko, LLP, No. 02-682, 540 U.S. ____ (2004), slip op. at 7. *See also U.S. v. Microsoft Corp.,* 253 F.3d 34, 53-54 (3d Cir. 2001); *Pacific Express, Inc. v. United Airlines, Inc.,* 959 F.2d 814 (9th Cir. 1992) (a competitor's decision to expand into areas previously served only by the plaintiff was not an act of willful monopolization but an example of lawful competition); *Brooke Group Ltd. v. Brown &*

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[27] The RCAs are not exclusive dealing agreements, and the participants are not obligated under the agreement to execute a specific volume of transactions on the Exchange. Staff notes that, in total, the seven RCA firms own CBOT seats valued at $25.6 million, which is $7.6 million more than is committed under the RCAs. If the CBOT were to lose its Treasury business to the Exchange, the value of these seats could be expected to decline dramatically, and the RCA participants could suffer significant capital losses. Because the RCA Participants currently have a larger financial interest in the CBOT than in the USFE, there is no economic incentive to direct, or recommend that customers direct, orders to the USFE.

Williamson Tobacco Corp., 509 U.S. 209 (1993) (price reductions designed to meet price competition of competitors was not "predatory" under the Sherman Act). [28] In short, where business practices are challenged on antitrust grounds, courts will distinguish between acts that reflect competition on the merits and acts that have no apparent business purpose other than their adverse effect on competitors.

In evaluating the effects on competition of a particular business arrangement, it is appropriate also to consider the practice's pro-competitive efficiencies. The RCAs, which will remain in effect for only three years and may not be extended,[29] have been structured to create an incentive for Participants to provide a minimal level of seed liquidity in order to enhance the USFE's prospects for viability as a new entrant into the market. Here, the new entrant possesses little or no market power in the relevant market, the agreements are of fixed and short duration, and there are pro-competitive efficiencies and other business justifications for the RCAs. For these reasons, it is unlikely that the arrangement would unreasonably restrain trade.

On the contrary, staff believes the RCAs will promote competition by providing seed revenue and encouraging development of liquidity for a start-up exchange which, in turn, has the potential to enhance competition in the futures industry by providing customer choice, increasing market efficiency, enhancing liquidity, and lowering costs. Staff notes that, since the USFE's application, the CBOT announced lower fees for execution and clearing of U.S. Treasury futures and options contracts. In particular, on January 1, 2004, CBOT's fees were 10 cents and 90

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[28] *See generally* discussion of predatory pricing, "Fair Competition Issues", *infra* at 127; Federal Trade Commission (FTC) comment letter at 3-4.

[29] The shorter the duration of such an agreement, the less likely it will be held to be unreasonable. *See, e.g., Barry Wright Corp. v. ITT Grinnell Corp.,* 724 F.2d 227 (1st Cir. 1983). This is particularly true where the entity does not possess significant market power. *See U.S. v. Jerrold Electronics,* 187 F.Supp.2d 545 (E.D. Pa. 1960), *aff'd per curiam* 365 U.S. 567 (recognizing a business justification where an exclusive dealing arrangement of limited duration was necessary to help a new entrant establish its business).

cents, respectively, for members and nonmembers for transactions executed electronically on e-CBOT; at the same time last year, these fees were 15 cents and $1.25.

Because traders are likely to seek liquidity and thus to trade where active trading occurs, staff views the arrangement as a reasonable way to solve the network effect problem facing a new exchange. Without seed liquidity, new entrants will likely encounter great difficulty in creating the market conditions -- particularly liquidity, depth and open interest -- necessary to compete effectively with the dominant market. Accordingly, it is staff's view that the RCAs are consistent with the objective of the Commodity Futures Modernization Act of 2000 (CFMA)[30] to "promote responsible innovation and fair competition." The FTC comment letter, described more fully in Section VII below, supports this view.[31] For these reasons, the staff believes that, when reviewed against the standards set forth in Section 15(b) of the Act and Core Principle 18, the RCAs are acceptable.

C. Strategy Board Trading

The USFE centralized market Trading System includes a trading forum known as the Strategy Board, which allows market participants to directly bid, offer and trade 45 different option strategies. Strategy Board orders or quotes are orders or quotes to buy and/or sell simultaneously various combinations of options or option and futures contracts listed for trading on the Exchange. The Strategy Board trading functionality enables market participants to create an individual strategy based on predefined strategy types, announce the strategy to the entire market via a request for quotes, and then execute that strategy trade against responsive quotes

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[30] Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000). The CFMA, which became effective on December 21, 2000, amended the Act and, among other things, overhauled the regulatory scheme applicable to DCMs and other trading facilities.

[31] *See* FTC comment letter at 2.

through the Strategy Board's price-time priority trade-matching algorithm. The Trading System provides for 45 predetermined types of combination trades.

Members may cause the Strategy Board to open a separate order book for a strategy by creating a user-defined strategy from the list of 45 available strategies. Strategies thus created by market participants are visible to all Exchange participants and can be traded via separate strategy order books that are available to all USFE members. Strategies may include a futures component, but may not consist entirely of futures components.[32]

Orders for strategy trades may be entered only when each of the products comprising the strategy is in the trading period. Only limit orders and quotes for strategies are admissible and eligible for matching. A new order number and time stamp would be assigned in the event of modifications to the order limit and/or an increase in the order quantity. Strategy orders would only be matched against orders for the same strategy, and only for entire units of the respective strategy. Partial executions would result in entire strategy positions, but in fewer such contracts than the quantity desired. Each contract that is a component of a Strategy Board transaction would be posted individually at the virtual price at which all legs of the strategy would have matched. Market participants would be able to offset component positions resulting from a strategy trade by either executing an offsetting Strategy Board transaction or legging out in the appropriate USFE centralized market. All open strategy orders and strategy quotes would be removed from the Strategy Board at the end of the trading day.

By establishing a trading forum dedicated solely to complex option strategies, the USFE hopes to appeal to traders who otherwise would only be able to accomplish such strategies by

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[32] Eighteen of the 45 types of predetermined combination trades are option volatility strategies involving the underlying futures contract. For these strategies, the member enters the price and size of the futures leg of the strategy combination into the Trading System.

either executing off-market, bilaterally-negotiated transactions or by trading each strategy leg separately (and facing the consequent execution risk). Staff believes that Strategy Board trading should serve as a beneficial adjunct to the USFE's centralized markets for futures and options trading, and, in combination with those centralized markets, should, as required by Core Principle 9, "provide a competitive, open, and efficient market and mechanism for executing transactions."

D. Volatility (Vola) Trading Facility

The USFE Vola Trading Facility is an off-centralized-market mechanism designed specifically to facilitate establishing futures positions for option traders wishing to create a delta neutral hedge position.[33] The USFE notes that traders holding complex option strategy positions face execution risk if they establish the hedge futures position on the Trading System, because there is no assurance that the futures transaction price would be equal to the reference price on which the delta-neutral hedge option strategy is based. By using the Vola Trading Facility, counterparties with opposing option positions can eliminate execution risk associated with establishing their delta-neutral hedge futures positions on the USFE.[34]

Vola trades are permitted only for the USFE option contracts and the underlying futures contracts. The option positions may be established either on the Exchange's Trading System

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[33] Delta hedging is a hedging method that takes advantage of an option's delta (*i.e.*, the change in the price of an option for a one-tick change in the price of the underlying asset). A deep in-the-money option has a delta that approaches one, while a deep out-of-the-money option has a delta that approaches zero. An option that is at-the-money has a delta of about one-half.

[34] Theoretically, a delta-neutral hedge position would not change in value if the price of the underlying asset changed in price by one tick. For example, if a trader has written 1,000 at-the-money call options, the trader's option position is on the short side of the market, so a delta-neutral position would require the trader to buy futures contracts. The question is how many long futures contracts would be necessary for a delta-neutral hedge. If the delta on those options is exactly one-half, then the trader will need to buy 500 futures contracts (0.5 X 1000 = 500). If the futures price increases by one point, then the value of the futures position increases by 500 points and the value of the option position decreases by 500 points (1000 X 0.5 X (-1)). Thus, the value of the overall position does not change.

(through outright trades executed on the Trading System or via the Strategy Board) or in the OTC (with the trades then brought to the Exchange through the Block Trade Facility). Options on which Vola trades are based must be listed for trading by the USFE. Vola trades based on customized option contracts are not permitted.

The USFE's Vola trading rules do not specify a minimum transaction size. The trader specifies the number of option contracts included in the original option transaction to be delta hedged and then specifies the number of futures contracts. The number of futures contracts, which may not vary by more than ten percent from the number necessary to be delta-neutral, is calculated based on an option pricing formula that takes into consideration the number of option contracts involved in the position and the options' deltas. The derived number of futures contracts needed to create the delta neutral position is then rounded down to the nearest whole number. For example, if a trader sells 750 call options that have a delta of 0.555, then the number of futures contracts in the Vola trade would be 416 (750 X .555 = 416.25). The facility allows the two parties to create a futures position equal to the calculated amount, plus or minus ten percent.

The option positions must have been established on the same trading day that the Vola trade was executed. The USFE requires that the transaction number of the option transaction on which the Vola trade is based be entered into the Vola trading screen and requires that the counterparty confirm the trade. Generally, the price of the futures transaction must be no more than five ticks outside of the range of that trading day's high and low.[35] The USFE staff confirmed to Commission staff that the trading range is defined by the high and low transaction prices of the futures contract up until the time that the Vola trade is entered. Staff believes that

[35] The Vola trading rules also would establish an equivalent pricing parameter tied to theoretical prices when there has been no recent trading in the related futures contract at the time of the Vola trade.

the Vola Trading Facility should also serve as a beneficial adjunct to the USFE's centralized markets for futures and option trading, and, in overall combination with those centralized markets, should, as required by Core Principle 9, "provide a competitive, open, and efficient market and mechanism for executing transactions."

V. Staff Analysis and Response to Comments

A. Comments from the Department of the Treasury and the Board of Governors of the Federal Reserve System

As noted above, the Commission forwarded the USFE application to the Treasury and the Federal Reserve on November 5, 2003. The Commission provided the Treasury and the Federal Reserve with additional information related to the USFE application on December 17, 2003. The Treasury reviewed the USFE's designation application and contract specifications with a view to discerning any potential effect on the debt and financing requirements of the federal government as well as the efficiency and integrity of the cash market for U.S. government securities. By letter dated December 18, 2003, the Treasury concluded that the introduction of additional derivative products could boost trading volume, facilitate hedging, enhance liquidity, and reduce costs for Treasury securities and related financial instruments. In response to concerns over the foreign ownership of the USFE, the Treasury noted that a majority of primary dealers in Treasury securities are foreign owned, and that a large percentage of publicly held marketable U.S. Treasury debt is held by foreign entities. The Treasury further noted that competition in financial markets, both domestic and global, improves the U.S. economy by fostering innovation and efficiency. The Treasury concluded by stating that it does not object to the Commission designating the USFE as a contract market if the Commission finds that the USFE meets the requirements of the Act.

By letter dated December 18, 2003, the Federal Reserve stated that expanded venues for the trading of derivatives could offer more opportunities for assuming and hedging positions in Treasury instruments thereby enhancing market liquidity. The Federal Reserve also considered the foreign ownership of the USFE. It believes that the Commission's designation process permits the Commission to adequately address potential concerns raised by the ownership structure of the USFE and that such concerns do not require erecting barriers to foreign entry. The Federal Reserve stated that competition in our financial markets has been enhanced by the direct presence of non-U.S. entities in the domestic marketplace and that such competition enhances efficiency and fosters innovation. The Federal Reserve concluded that the process described by the Commission in Congressional testimony -- in which the Commission stated that it is committed to providing a level regulatory playing field and that the USFE's application will be evaluated against the same designation criteria and core principles as applied to other contract markets -- is appropriate.

B. Comments from Other Federal Agencies and from the Public

1. Overview

In response to its first request for public comment, the Commission received ten comment letters. The comment letters are evenly divided between those that supported the application and those that opposed it or were critical of some aspect of it. The five commenters that supported the application include the Futures Industry Association (FIA), one trading firm (Interactive Brokers Group, LLC), two individual traders (Jack Rhodes and Klaus Gagel), and the publisher of a magazine on derivatives trading (Patrick L. Young). The five commenters that opposed the application include the two futures exchanges based in Chicago, Illinois – the CBOT and the CME – two traders (DRW Trading Group and Sascha Bauer) and one member of the public (Brian Hynes).

Following the Commission's receipt of the comment letters from the CBOT and the CME, the NFA submitted a letter responding to the portions of those letters that questioned the ability of the NFA to provide regulatory services to the USFE. The USFE also filed, on November 18, 2003, a letter responding to issues raised in the comment letters that had been filed by that date. On December 9, 2003, the CBOT filed a second comment letter responding to the USFE's December 18 letter.

In response to the second request for public comment, the Commission received a total of twenty-seven comment letters. The comment letters include a third letter from the CBOT and a second letter from the CME. The FTC submitted a letter supporting the application.[36] The Managed Funds Association (MFA) and Professors Robert A. Schwartz and Avner Wolf submitted comments in support of the application. The bulk of the remaining comment letters were from current or former members of the CBOT or the CME that opposed the USFE's application or were critical of some aspect of it (Jerrold M. Duzenman, Thomas G. Bernicky, Paul L. Richards (two letters), Carl M. Zapffe, Mark T. Rowley, James L. Weiner, David Fox, Nickolas J. Neubauer, Gary R. Knight, David M. Heinz, Atlantic Metals, Limited (two letters), Justin Dugan, Lee B. Stern, Michael D. Morelli, and Edward C. Spencer). Additional comment letters critical of the USFE's application were submitted by a registered introducing broker (Celtic Brokerage Inc.), a trader (Nicholas C. Zagotta), the publisher of a newsletter (John Lothian), and an academic (Daniel G. Weaver). Furthermore, on January 26, 2004, the

[36] In addition, the Chairman of the FTC submitted a letter explaining that the earlier FTC comment letter addressed the likely impact of new entry on consumers but did not address the regulatory issues related to the USFE's application.

Commission received a joint letter from seven separate trade associations[37] expressing support for the USFE's application and urging the Commission to conclude its review so that market participants could prepare for the imminent roll of open interest in the expiring nearby active Treasury contract.

Many of the comment letters address business plans that have been announced by the USFE but are not incorporated in the application. For instance, the USFE proposed in marketing materials its intent to establish a clearing link with Eurex Clearing AG and to provide members with volume-based rebates during the first two years of the Exchange's operation (referred to in the letters as "payment for order flow").[38] The USFE has not formally submitted anything to the Commission that would result in the implementation of either a clearing link or volume-based rebates.[39] Accordingly, staff is not able at this time to analyze the merits of those proposals and whether they would conform to the Act and regulations thereunder. Nevertheless, to the extent permitted by the available information, the issues that may be raised by any such future proposals are discussed below.[40] Furthermore, the USFE and C Corp have submitted

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[37] The seven trade associations are: FIA, MFA, The American Bankers Association, The Bond Market Association, Financial Services Roundtable, International Swaps and Derivatives Association, and Securities Industry Association.

[38] The term "payment for order flow" is more commonly used to describe incentives offered by securities exchanges or OTC market makers to securities brokers to direct orders to a particular exchange or an OTC dealer. Unlike the futures marketplace, where futures contracts generally are not fungible and trading historically has been concentrated on one exchange, the identical and fungible nature of securities listed or traded by multiple exchanges or dealers gives securities brokers the ability to direct customer orders to a variety of trading venues.

[39] For a discussion of the incentive aspects of the RCA, *see* Section VI *supra*. Three commenters, without providing additional details, characterized the merger between the USFE and BTEX as a "payment for order flow" program.

[40] The CBOT has also alleged that the USFE has made false claims, including false claims in marketing materials regarding its registration status with the Commission. The document containing the alleged false statement regarding the USFE's registration status appears to be a PowerPoint marketing presentation. To staff's knowledge, the marketing presentation was not posted on the USFE's website. Furthermore, the marketing presentation contains a disclaimer that states that the USFE will apply to the Commission for DCM designation and that, before trading commences, the USFE must be designated as a DCM by the Commission. Staff also notes that, on December 16, 2003, Eurex and C Corp issued a press release representing that the Exchange would launch on February 1, 2004, and that the Global Clearing link would launch on March 28, 2004. In a letter dated December 19, 2003, the (continued)

undertakings to the Commission that will ensure pre-implementation regulatory review of any clearing link or of any non-traditional form of incentive program.[41]

2. Favorable Comments

Most of the commenters that support the application strongly believe that the competition resulting from approving this application will benefit the futures industry, its users and the economy as a whole. For instance, one commenter noted that open and free competition and choice not only benefit U.S. and non-U.S. users of the global futures markets but also "will facilitate the formation of capital and liquidity and its efficient allocation across the globe."[42] Another commenter noted that "free competition is the only way that the futures and options trading world can reach its greatest possible critical mass and maximize the potential for cost effective risk transfer opportunities."[43] FIA commented that approval of the application would be consistent with the goal of the CFMA to "promote responsible innovation and fair competition."[44]

Several commenters believe that a totally electronic trading platform such as the USFE's platform will be beneficial because it will result in lower costs, greater transparency, more competition and more efficiency. One commenter also emphasized that one of the benefits of approving the application is that it will provide a perfect opportunity to test which dealing platform -- open outcry or electronic -- is preferred by the end user customer. In that

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Directors of DMO and the Division of Clearing and Intermediary Oversight jointly directed that the press release be retracted immediately with explanation and requested that C Corp, Eurex Frankfurt AG, and the USFE inform the Divisions in writing of the specific actions that they would take to prevent such inaccuracies from occurring in the future.

[41] *See* Section VIII below.

[42] Letter of Interactive Brokers Group, LLC.

[43] Letter of Patrick L. Young.

[44] *See* Section 3 of the Act.

commenter's view, providing customers with choices such as this is "one key step in keeping the financial infrastructure of the U.S. a diverse and dynamic business which will continue to lead the world in its innovations for many years to come."[45]

Another commenter, the MFA, believes that the designation of additional futures exchanges will foster an environment of healthy competition and technological innovation. The MFA believes that the array of products domestically available to U.S. investors could increase significantly with the designation of the USFE. The MFA also believes that the USFE's presence in the U.S. marketplace could enhance the liquidity of contracts currently accessible within the U.S. marketplace.

In considering the effects of competition, Professors Schwartz and Wolf likewise conclude that intermarket competition between exchanges with different market structures is healthy and will result in lower costs for customers. The professors state that such competition forces established exchanges to overcome the inertia that stymies their rate of innovation. The professors also recognize that competition among exchanges necessarily leads to a measure of market fragmentation, but believe that fragmentation is justified by the substantial benefits derived from competition.

The FIA's comment letter contains some data on cross-border trading, including data indicating that U.S. participants account for 25 percent of the turnover in European benchmark products traded on Eurex. The FIA posits that, through the USFE, Eurex is essentially offering to repatriate a significant portion of volume that is attributable to U.S. participants. In the FIA's view, this will only benefit U.S. participants and their intermediaries because U.S. customers will be able to enjoy the full scope of the U.S. regulatory program, including the segregation

[45] Letter of Patrick L. Young.

requirements of the Act and Commission regulations. This, according to the FIA, will result in less risk and lower transaction costs. Furthermore, the FIA suggests that foreign customers may also be interested in trading Eurex products through the USFE in order to clear their positions through a single firm.

The FIA also believes that the USFE meets the criteria specified in the Act and the Commission's regulations and that the FIA is unable to identify any public policy or regulatory issue that the Commission has not already successfully addressed in the past. Indeed, in the FIA's view, the Commission can have greater confidence in the operational and administrative capabilities of the USFE than it may have with respect to other applicants because the USFE is using an enhanced version of an established trading system, its contracts will be cleared by C Corp, and the NFA will provide certain market surveillance and compliance programs. The FIA further commented that the USFE's indirect owner, Eurex Frankfurt AG, operates a globally respected exchange that is already well known to the Commission and that many U.S. market participants are active traders on that exchange.

The FTC's comment letter addressed the pro-competitive impact of the USFE's application, observing that economic theory indicates that consumers would likely benefit from having additional competition in the market for futures trading services. Specifically, the FTC notes that competition from new entrants can encourage producers to become more efficient and responsive to the marketplace. The agency cautions that restraints on new entry can harm consumer welfare by stifling innovation and allowing existing firms to charge higher prices. The FTC believes that the competitive pressures introduced by the USFE's entrance into the futures industry will likely benefit consumers of futures trading services, noting that vigorous competition allows consumers to reap the benefits of lower prices and higher quality. In

particular, the FTC cites as positive effects of intermarket competition the marked narrowing of bid-ask spreads, the introduction of competing and more efficient business models, and the exposure of consumers to lower transaction costs. The FTC minimized concerns relating to the acquisition of market share through "predatory" practices such as below-cost pricing, incentives or rebates to market participants. It points to several important antitrust decisions in which the Supreme Court has made clear that low prices are "a boon to consumers" and to legal scholarship endorsed by the Court which concludes that actual predation in the sense of pricing below cost rarely occurs.

3. Unfavorable Comments

The CBOT and the CME strongly opposed the application, claiming that the application is materially incomplete and that the USFE has failed to demonstrate how it would meet many of the standards mandated by Congress. Together, the CBOT's and the CME's comment letters total 77 pages. The CBOT also submitted over 200 pages of exhibits with its first comment letter. The comments of the CBOT, the CME, and the other commenters that opposed the application, in whole or in part, are discussed in detail below.

a. Ownership and Governance Issues

(1) Ownership of the USFE

The CME contended that the USFE would be controlled by a foreign entity, Eurex Frankfurt AG, and that, accordingly, the Commission would have no jurisdiction over the true controlling persons of the USFE.[46]

[46] Staff notes that the comments on the USFE application predated the acquisition of BTEX and the resultant 20% equity stake in the USFE now held by the EPH. Nonetheless, the USFE will still be majority owned, indirectly, by a foreign entity. Accordingly, staff believes it is still appropriate to consider the foreign ownership issues that were raised by commenters.

Staff does not believe that foreign ownership of an applicant, whether direct or indirect, should be an obstacle to designation. Staff notes that neither the Act nor the Commission's regulations establish any special criteria for foreign-owned applicants. The USFE itself is a Delaware limited liability company majority-owned by a Delaware corporation and, if designated, it will have an obligation to comply with all applicable provisions of the Act and the Commission's regulations, regardless of the location of the Exchange's ultimate owners. Staff generally believes that permitting the establishment of any new contract market, whether domestic or foreign-owned, should benefit the U.S. futures industry as it should enhance competition among exchanges and offer additional or improved risk management tools for market users.

If any DCM violates the Act, Commission regulations or orders, the Commission can investigate and, among other things: (1) take administrative action against the DCM in accordance with Sections 6(b) and 6b of the Act; (2) file a civil injunctive action against the DCM under Section 6c(a) of the Act; or (3) take emergency action under Section 8a(9) of the Act, if deemed necessary. The Commission also may take action against any director, officer, agent or employee of a DCM, or any other person, including controlling persons of a DCM and aiders and abettors who violate the Act, Commission regulations or orders, pursuant to Sections 6(c), 6(d), 6b and 6c of the Act.

The Commission's authority under the Act to reach controlling persons as defined by the Act would extend beyond the territorial limits of the U.S. to wherever persons or information may be located. Section 13(b) of the Act provides that any person who directly or indirectly controls another person who has violated the Act or the Commission's regulations or orders, may

be held liable for the violation to the same extent as the primary violator.[47] The determination of who constitutes a "controlling person" requires a facts and circumstances inquiry. Pursuant to Section 13(b), if a controlling person knowingly, or in bad faith, induced an exchange to violate the Act or regulations thereunder, that person would be subject to prosecution by the Commission.

For the purpose of any investigation or proceeding under the Act, Section 6(c) authorizes the Commission to:

> Administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records that the Commission deems relevant or material to the inquiry. The attendance of witnesses and the production of any such records may be required from any place in the U.S., any State, or any foreign country or jurisdiction at any designated place of hearing.

Subpoenas seeking the attendance of witnesses or production of records located outside the U.S. are served in accordance with the procedures prescribed by the Federal Rules of Civil Procedure for service of process in a foreign country. Staff notes that when persons and information are located abroad, the Commission can also invoke the aid of its enforcement counterparts overseas.

In the case of Germany, the Commission has entered formal, bilateral enforcement information sharing arrangements (also known as Memoranda of Understanding or MOUs) with the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), and its predecessor agency, the Bundesaufsichtsamt für Den Wertpapierhandel (BAWe). In fact, BaFin's cooperation has been critical to the Commission's ability to combat violations in a number of instances, by assisting the Division of Enforcement in obtaining trading and bank records, registration histories, complaint and investigation files, and most recently, obtaining the statement of a witness. Staff

[47] Liability under Section 13(b) is premised on the controlling person knowingly, or in bad faith, inducing the act or acts constituting the violation. 7 U.S.C. § 13c(b).

expects, based upon a longstanding, cooperative relationship with the German authorities under the bilateral MOU and under prior, less formal arrangements, that should circumstances require assistance from Germany in connection with the USFE's operations, such assistance will be forthcoming in accordance with the provisions of the MOU. Staff also notes that Germany has affirmed its commitment to international information sharing by becoming a signatory to various multilateral information agreements.[48]

For all of these reasons, staff has concluded that the indirect ownership of 80 percent of the USFE by foreign entities should not be an impediment to the USFE's ability to meet the responsibilities of a DCM under the Act and the Commission's regulations. Staff believes that the Commission has ample authority to monitor and enforce the USFE's compliance with those requirements.

(2) The USFE Board

The CBOT in its first and second comment letters raised issues with respect to the USFE's use of single-person Board of Directors. Since those comment letters were submitted, the USFE amended its Bylaws to establish a 12-person Board.[49] Under Section 5.2 of the Bylaws, the USFE Board will have 12 Directors with six of the Directors appointed by the Class A shareholder (the USEH) and three of the Directors appointed by the Class B shareholder (the EPH). The other three USFE Directors will be Public Directors, who will represent arbitrage firms, institutional investors, and independent clearers, with one Director representing each

[48] *See* discussion at pp. 65-67, *infra*.

[49] While the USFE has expanded the size if its Board, staff notes that the Act and the Commission's regulations do not establish minimum or maximum size requirements for contract market governing boards. The USFE's use of a single director Board during the pendency of its application was neither unusual nor inappropriate for a contract market applicant as single-person boards facilitate quick decision-making during an enterprise's start-up period.

group.[50] All of the Directors will have to meet the fitness standards established by USFE Bylaw Section 5.6. Commission staff has reviewed that provision and believes that it is consistent with the governance fitness requirements of Core Principle 14.[51]

(3) Role of Eurex & Eurex Frankfurt AG

(a) Handling of Market Supervision Responsibilities

The CBOT commented that it is unclear whether market supervision functions will be handled by the USFE or the NFA and whether they will be conducted in the U.S. or in Frankfurt. The USFE has clarified to Commission staff that USFE employees located exclusively in Chicago will handle market supervision responsibilities for the Exchange.[52] The USFE has contracted with Eurex Frankfurt AG to provide market supervision functions on a backup basis in the event of problems with the Exchange's Chicago facility. When performing backup market supervision for the Exchange, Eurex Frankfurt AG will operate pursuant to the decisionmaking authority of the USFE. Staff notes that the use of a foreign entity as a service provider is not unusual. For instance, the CBOT itself used Eurex personnel for primary market supervision duties during the early stages of trading on the a/c/e platform. Similarly, LIFFE currently performs comparable system administration functions for the NQLX.

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[50] The selection of Public Directors will be made with input by both Class A and Class B shareholders. The Class B shareholder nominates five candidates for each of the Public Director positions, and the Class A shareholder selects one Public Director from each of the groups of nominees.

[51] Staff notes that, under Core Principle 14, the Commission may at any time require a DCM to provide fitness information to the Commission with respect to its board members.

[52] The USFE market supervision staff will be responsible for the administration of the trading platform, including, among other things, opening and closing markets, handling trading halts due to volatility interruptions, resolving mistrades, switching from normal to fast markets and back, and maintaining the proper operation of the Trading System.

(b) Outsourcing of Market Supervision to a Non-Registered Entity

The CME and the CBOT both contended that the USFE's plan to outsource market supervision responsibilities to Eurex Frankfurt AG does not comply with Section 5c(b) of the Act and its requirement that DCMs limit the delegation of core principle functions to "a registered futures association or another registered entity."[53]

Staff believes that the restriction of Section 5c(b) does not apply to the USFE's arrangement with Eurex Frankfurt AG. Eurex Frankfurt AG would provide market supervision services on a strictly backup basis in the event that the USFE market supervision staff was unable to conduct operations. These services would be provided pursuant to a USFE-Eurex Frankfurt AG contractual agreement under which the USFE would maintain decisionmaking authority over Eurex Frankfurt AG staff when rendering services to the USFE. In light of this retention of authority by the USFE, staff believes that the USFE has contracted out, rather than delegated, a core principle function to Eurex Frankfurt AG. Staff notes that at the time that the Commission adopted its Part 38 regulations, it very explicitly stated that DCMs, consistent with Section 5c(b), may only delegate core principle functions to a registered futures association or a registered entity, but that there is no such limitation on contracting out core principle functions.[54]

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[53] As used in this context, staff believes that the terms "outsource" and "contract out" have the same meaning. With respect to the distinction between DCMs contracting out versus delegating core principle functions, the Commission has stated that the distinction between the two is premised on the degree of control retained by the DCM. In a delegation, the DCM confers upon another the authority to act in the DCM's name. By comparison, in a contracting out situation, the DCM maintains a degree of control over the contractor and the contractor would not have authority to make regulatory decisions on behalf of the DCM. 66 Fed. Reg. 42256, 42266 (August 10, 2001).

[54] *Id.*

Accordingly, Commission staff has concluded that the USFE's retention of Eurex Frankfurt AG for backup market supervision services is not inconsistent with Section 5c(b).[55]

(c) Competency of Eurex Frankfurt AG to Handle Market Supervision

The CME and the CBOT both commented that Eurex has experienced a number of squeezes, corners and price manipulations in its German government debt futures contracts, and that its response to those episodes was muted. Accordingly, they contend that the USFE should not be permitted to delegate any regulatory functions to Eurex Frankfurt AG.

As discussed previously, the NFA will have market surveillance responsibilities for the USFE contracts and it, not Eurex Frankfurt AG, will be responsible for monitoring for squeezes and manipulations in the USFE contracts. Eurex Frankfurt AG's role will be limited to serving as a backup market supervision facility responsible for administration of the trading platform in the event that the USFE's primary market supervision facility in Chicago is inoperable.

Furthermore, staff does not believe that reports of irregular trading activity at Eurex are relevant to its consideration of the USFE application. Surveillance of the USFE markets will be conducted by the NFA under the oversight of the Commission, while surveillance of Eurex contracts is conducted by Eurex in Germany under the oversight of the German regulatory authority. In addition, in listing contracts for trading, the USFE must comply with all DCM requirements, including Core Principle 3, which provides that contract markets list contracts that are not readily susceptible to manipulation. Moreover, as noted above, staff does not believe that

[55] The Commission has stated that in "using contractors to fulfill a self-regulatory function, it is the exchange's responsibility to ensure that its obligations under the Act are met." *Id.* Hence, the USFE will ultimately be responsible for meeting the designation criteria and core principles, including those matters contracted out to Eurex Frankfurt AG.

it is inappropriate for Eurex Frankfurt AG to handle backup market supervision responsibilities for the USFE.[56]

Finally, Commission staff has inquired into the allegations of manipulation at Eurex. Staff understands that there have been several measures taken to mitigate the threat of squeezes in German government debt futures contracts. For example, in July 2001, Eurex instituted speculative position limits in the delivery month. In addition, the German government agency equivalent of the trading desk of the New York Federal Reserve announced that it stands ready to sell its special reserve of German bonds on a short-term basis in the repurchase market in the event of a shortage of bonds in the cash market. Staff further found that there have been no successful squeeze attempts in trading on Eurex since these measures were instituted.

(4) Role of Foreign Ownership

The CBOT and the CME asserted that the operation of a DCM by a "foreign entity" raises special issues that must be considered in reviewing the application. Although some or even most of the ultimate owners of the USFE may be located outside the U.S., staff does not believe that it is accurate to characterize the USFE as being "operated" by a foreign entity. Nevertheless, given the relationship of the USFE to entities located outside the U.S., and their potential influence over the operations of the USFE, staff has carefully considered each of the issues that the CBOT and the CME have raised relating to such "foreign operation" of the USFE, and staff does not believe that they provide any basis for not designating the USFE as a contract market.

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[56] Notably, Commission staff did an extensive review of the market supervision program at Eurex Frankfurt AG in connection with the implementation of the CBOT trading on a/c/e, including a three-day visit to Frankfurt in the company of CBOT employees. At that time, Commission staff found that Eurex Frankfurt AG handled their market supervision responsibilities in a satisfactory manner.

First, the CBOT asserted that there are special risks inherent in allowing any foreign entity to operate a DCM because the entity may be expected to have its principal allegiance to its home government and country, rather than to the U.S.[57] Staff observes that upon designation the USFE will be a DCM subject to all the requirements of other DCMs and, like other DCMs, will be accountable to the Commission for ongoing compliance with those requirements. If the USFE fails to maintain continuing compliance with the designation criteria or core principles, staff would recommend that such action be taken as may be appropriate. In this regard, staff believes that the Commission has substantial authority to address any problems that may arise with respect to the operation of a DCM – whether domestic or foreign-owned. Staff also notes that, to date, the Commission has not experienced any problems with foreign ownership of DCMs.[58]

Second, the CBOT asserted that the Commission would face an impediment to the exercise of its oversight responsibilities when a foreign entity "operates" a DCM and that the Commission's ability to apply its full enforcement powers is simply not as clear or immediate when the owner/operator is a foreign entity. Staff emphasizes that the USFE and its staff will be located in the U.S. and that the Commission will exercise full and unfettered oversight of the USFE. However, as previously discussed, should it be necessary to investigate or prosecute violations of the Act or regulations committed by persons or entities located outside the U.S., the

[57] The USFE states in response that its interests do not conflict with the national interests of the U.S. and that the public interest is served by competition in the provision of exchange services.

[58] As previously discussed, the NQLX has had significant foreign ownership since being designated in 2001. Of course, any DCM that demutualizes and has publicly listed shares is also likely to have some degree of foreign ownership. *See* discussion at pp. 30-31 *supra*.

Act,[59] related laws,[60] and cooperative enforcement arrangements[61] provide the Commission with ample authority to pursue such matters. Furthermore, to the extent that the Commission may encounter difficulties in pursuing violations of the Act or regulations committed by persons located abroad, that issue exists today with respect to the activity of all foreign persons that participate, directly or indirectly, in U.S. markets – including foreign traders on U.S. exchanges, foreign owners of FCMs and other authorized intermediaries and foreign owners of exchanges.

Third, the CBOT asserted that concerns with respect to trading U.S. government debt security futures and options should be heightened when the DCM is owned by a foreign entity. There is nothing in the Act to prohibit a foreign-owned DCM from offering products based on U.S. government debt securities. There also is nothing in the Act to prohibit a foreign exchange from offering products based on U.S. government debt securities. In this regard, LIFFE listed for trading futures and options on U.S. Treasury bonds in the 1980s and early 1990s. In 1988, over two million LIFFE U.S. Treasury bond futures were traded.

Furthermore, if and when the USFE lists these products, they will be traded subject to all the same protections that apply when such products are traded on any other DCM. Staff also notes that 12 of the 22 firms currently serving as Primary Dealers in the market for Treasury securities are foreign-owned, and that a large percentage of the publicly-held marketable U.S. Treasury debt is held by foreign entities. Significantly, in their respective comment letters, the

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[59] Section 6(c) of the Act expressly authorizes the Commission to compel the attendance of persons located in foreign countries at Commission hearings. Sections 6(b) and 6b of the Act authorize the Commission to bring administrative enforcement actions against any director, officer, agent or employee of any exchange, wherever located, for violations of the Act, regulations and orders of the Commission. Section 13(b) of the Act imposes "controlling person" liability on persons, wherever located, who do not act in good faith, or knowingly induce, directly or indirectly, the act or acts constituting a violation of the Act or the Commission's regulations committed by another person.

[60] *See* Fed. R. Civ. P. 4(f) (providing for service of process in a foreign country).

[61] *See* discussion at pp. 65-67, *infra*.

Treasury stated that it did not find the fact that the USFE is foreign-owned to be objectionable, and the Federal Reserve observed that foreign ownership should not be a barrier to entry, as any concerns regarding foreign ownership could be addressed in the designation process.

Fourth, both the CBOT and the CME raised questions about the possible adverse effects foreign ownership could have on the ability of the USFE or the Commission to act in an emergency. In their view, foreign ownership could influence the willingness of the USFE to take emergency action when necessary. The USFE has adopted Rule 804 to implement Core Principle 6, which requires DCMs to adopt rules to provide for the exercise of emergency authority, in consultation or cooperation with the Commission, where necessary and appropriate. Pursuant to USFE Rule 804, the USFE's CEO based in Chicago has discretion to take emergency action on behalf of the USFE. Any failure by the USFE to enforce this rule, or to otherwise comply with Core Principle 6, would result in appropriate action by the Commission.

The CME also suggested that foreign ownership could impair the effectiveness of an emergency action taken by the Commission, especially when the emergency results from governmental action in the jurisdiction of the foreign owner. Staff has considered this vague, yet potentially serious, concern but is unable to construct a scenario that would present the types of problems suggested. While the USFE, like any DCM, could question the wisdom or merits of a Commission emergency action, staff cannot envision circumstances that would result in foreign ownership causing the Exchange to refuse to comply with an order issued by the Commission declaring a market emergency. Should such circumstances present themselves, staff believes that the Commission has adequate remedies available to it.

Fifth, the CBOT asserted that foreign ownership of a DCM might present financial integrity risks, specifically where the foreign owner also owns a foreign board of trade. The

CBOT suggested that, if a firm that is a clearing member of both the foreign board of trade and the U.S. DCM became troubled, the customers trading on the foreign board of trade might be favored (presumably, through the foreign owner's influence over the U.S. DCM). However, the rights of customers of a troubled firm to segregated funds are governed by Subchapter IV of Chapter 7 of the Bankruptcy Code (11 U.S.C. §§761-766) and the Commission's bankruptcy rules (Part 190), and thus the identity of the owners of the DCM is irrelevant.

The CBOT also suggested that U.S. customer funds might be at risk where a firm has memberships at both the DCM and the commonly-owned foreign board of trade if the foreign board of trade does not have segregation and net capital rules equivalent to U.S. standards. However, a firm trading on behalf of U.S. customers on a DCM must be an FCM. An FCM is subject to the Commission's net capital rule, regardless of whether it is also a member of a foreign board of trade, and U.S. customer funds would be subject to the Act and the Commission's segregation rules. Staff believes that the Commission would have direct authority over such a firm, regardless of the ownership of the DCM.

Finally, the CBOT suggests that the Commission consider whether the USFE application presents the need for additional international cooperative arrangements. Staff has reviewed its existing cooperative arrangements and does not believe that the application warrants any new information-sharing arrangements or any revisions to existing arrangements. These cooperative arrangements, previously noted, are described below.

The Commission has a long-standing cooperative relationship with its German counterpart, the BaFin, and the BaFin's predecessor agency, the BAWe. The Commission and the BaFin have committed to providing each other with the fullest assistance permissible under the laws of the U.S. and Germany. The CFTC and the BaFin have entered into an information

sharing arrangement that provides for comprehensive regulatory cooperation. Under this bilateral MOU, signed on October 17, 1997, the BaFin and the CFTC have committed to provide each other with assistance in order to facilitate: (1) market oversight, including market and financial surveillance; (2) the grant of licenses, authorizations, waivers or exemptions for the conduct of futures businesses and futures processing businesses; (3) the inspection or examination of futures businesses and futures processing businesses; and (4) the investigation, litigation, or prosecution by the CFTC, or the BaFin, of activity that potentially violates the futures laws or regulations applicable in their respective jurisdictions, without regard to whether the activity described in the request for assistance would constitute a violation of the futures laws or regulations applicable in the jurisdiction of the regulator providing assistance. The assistance available under the MOU includes, without limitation: (1) providing access to information in the files of the regulator; (2) taking statements of persons; (3) obtaining information and documents from persons; and (4) inspecting or examining futures contracts, futures businesses, and futures processing businesses. The MOU provides further that, in circumstances where the regulator does not possess the legal authority to provide the assistance or information requested, it will use all reasonable efforts to obtain the aid of such other governmental agencies that can provide the assistance or information. The MOU also provides that, to the extent permitted by the laws and regulations of their respective jurisdictions, each regulator will use reasonable efforts to provide the other with any information it discovers that gives rise to a suspicion of a breach, or anticipated breach, of the laws or regulations applicable in the jurisdiction of the other. In requesting and providing assistance, the MOU contemplates an exchange of letters between the regulatory authorities, but in urgent circumstances such requests may be effected by summary

procedures transmitted by other means of communication, provided that such communication is later confirmed in writing.

More recently, the BaFin reaffirmed its commitment to international information sharing by becoming a signatory, along with the CFTC and twenty-two other regulatory authorities, to the Multilateral Memorandum of Understanding Concerning Consultation, Cooperation and the Exchange of Information of the International Organization of Securities Commissions (IOSCO MOU) announced by IOSCO and the Commission on October 16, 2003. The IOSCO MOU is similar in scope to the bilateral MOU described above, but also provides two unique features. First, each signatory is required to pass a rigorous screening process to ensure that the signatory has the necessary powers to comply with the MOU's provisions. Second, cooperation under the MOU is overseen by a Monitoring Group comprised of MOU signatories, which is empowered to review noncompliance by MOU partners.

Other international cooperative initiatives in which Germany has participated include the Declaration on Cooperation and Supervision of International Futures Markets and Clearing Organizations (Boca Declaration), and its companion Exchange Memorandum of Understanding (Exchange MOU). The Boca Declaration and companion Exchange MOU were created to address the problem of accessing information on large exposures where exchange member firms and market participants typically trade on multiple exchanges, and no single regulator or market authority has all of the information necessary to evaluate the risks in its markets. Under the Boca Declaration, the occurrence of agreed-upon triggering events affecting an exchange member's financial resources, positions, price movements, or price relationships, or events suggesting manipulation or other abusive conduct, will prompt the sharing of information.

In addition, under Designation Criterion 8 of the Act, a DCM must establish and enforce rules that will allow it to obtain any information necessary to perform any of the functions required for designation, including the capacity to carry out such international information sharing agreements as the Commission may require. In connection with its application for designation, the USFE has represented that it intends to enter into appropriate information sharing agreements such as the Boca Declaration.[62]

b. NFA Issues

(1) Role of the NFA

(a) Confidentiality of RSA with the NFA

The CBOT commented that the Commission should not continue to consider the USFE's contract market application until a final executed version of the USFE's RSA with the NFA is submitted and released for public comment.[63] Staff does not believe that the RSA should be made publicly available because release of such an agreement and other materials relating to compliance and surveillance procedures could potentially enable futures market participants to circumvent exchange rules.[64] Accordingly, staff believes that it is not necessary to release the NFA RSA or to delay consideration of the USFE application pending public comment on that document. Moreover, the USFE has provided a final executed version of the agreement to the

[62] The CBOT's additional concerns regarding insider trading risks presented by foreign ownership are addressed below.

[63] The Commission did not place the RSA on its website for public comment because it is subject to a confidentiality request by the USFE. The RSA contains both commercial and financial information and confidential surveillance techniques and procedures.

[64] For instance, these agreements often describe the criteria that regulatory service providers use to detect trading patterns that are indicative of abusive trading practices. Once particular transactions are selected out on the basis of these criteria, the regulatory service provider will perform a closer analysis to determine whether some violation occurred. If market users were able to learn these selection criteria, they might be able to fashion abusive trading schemes that evade detection by the regulatory service provider.

Commission, and staff has fully reviewed the agreement for purposes of determining its compliance with the designation criteria and core principles.

(b) Adequacy of the NFA's Trade Practice and Market Surveillance Programs

The CBOT and the CME both commented that the USFE has not demonstrated how it would detect and prevent either market manipulation or trade practice violations. The USFE has contracted with the NFA to provide regulatory services to the Exchange using its Trade Practice and Market Surveillance (TPMS) program. Notably, staff has reviewed the TPMS program in connection with not only the USFE application, but also in connection with four previous contract market applications -- the BTEX, Island Futures Exchange (now the INET Futures Exchange), Merchants' Exchange and OnExchange Board of Trade, Inc. Most recently, the Division of Market Oversight completed a review of TPMS in its rule enforcement review of the BTEX's trade practice and market surveillance programs.[65] On each of those occasions, staff found the TPMS program to be acceptable.

In performing market surveillance duties for the USFE, the NFA would utilize online quotation systems, computer-generated reports and other tools to conduct daily monitoring of prices, volume, open interest, clearing member and large trader positions, and market news for all contracts listed on the Exchange. The NFA would analyze this data each day through its Trade Analysis and Profiling System (TAPS). TAPS would retain each contract's historical price record and issue exception report alerts whenever upward or downward price moves exceeded preset parameters. TAPS would be used to view trade and volume information by clearing member or by firm, and to rank positions in each contract over a period of time. TAPS would

[65] CFTC Press Release 4847-03 (October 2, 2003)

also be programmed to send an alert to the NFA staff whenever any trader's proportionate position, relative to either total volume or open interest, exceeds preset parameters.

TAPS would have preset alerts to inform staff whenever a trader met the threshold for large trader status. Upon such an alert, the NFA would obtain a large trader report from the trader, and enter the information into TAPS's large traders list, which would have the ability to aggregate all positions held by related parties. With this type of information, the NFA would monitor large trader positions for concentrations of ownership and potential collusive or concerted activity by market participants. The NFA has represented that, if it appeared that any one trader or account controller had a concentration in a given commodity, the NFA staff would contact the trader or controller to determine the reason for the concentration. As contracts approached expiration, staff would also follow basis relationships to ensure that they were narrowing as expected.

With respect to trade practice surveillance, the NFA's TAPS system would generate daily exception reports designed to identify various types of potential trading abuses and other anomalous trading activity, including trading ahead of customers, wash trading, and marking the close. In addition, the NFA would use TAPS to conduct customized searches or reviews of the USFE's audit trail data. TAPS also would maintain the USFE trader profiles and, based upon these profiles, exception reports would alert the NFA staff to deviations from a trader's normal practices. Finally, the NFA would also analyze trades executed outside of the USFE's central marketplace (*e.g.*, EFPs, EFSs, block trades, and vola trades) to ensure that they were consistent with relevant Exchange requirements.

Staff has closely reviewed the above-described NFA measures and it believes that they should facilitate the detection and prevention of market manipulation and trade practice abuses.

Based upon this assessment, as well as upon its review of the other components of the application, staff has concluded that the USFE's application meets the requirements of Designation Criteria 1, 2, 3 and 6 and Core Principles 2, 4, 10, 11, 12, 13 and 14.[66]

(c) Adequacy of the NFA's Resources

The CBOT and the CME also commented that the NFA has not demonstrated that it possesses the resources necessary to effectively carry out compliance functions for the USFE.

Staff does not agree with the commenters' assessment of the NFA's compliance capabilities. Staff understands that initially the NFA will assign five TPMS staff members to handle regulatory services for the USFE. Those employees have significant industry experience and will be overseen by Yvonne Downs, a former Senior Vice President and Administrator of the Office of Investigations and Audits at the CBOT. The NFA also has represented that if there is a need, the TPMS program can utilize a number of additional employees who have been cross-trained, as well as draw upon a pool of 90 Compliance Department employees, and that the RSA includes a volume-based charge that will provide the NFA with the monetary resources to hire additional TPMS staff as volume grows.

[66] Staff notes that the CBOT's and the CME's respective comments on this point seemed to be premised on the assumption that the Commission cannot do a proper review under these designation criteria and core principles without the USFE submitting a proposed contract. In fact, contract market applicants are not required to include proposed contracts in their applications. Accordingly, in reviewing a contract market application for compliance with these provisions, staff evaluates, on a non-contract specific basis, the systems and procedures that the applicant and/or its regulatory service provider will use to detect and prevent manipulation and trade practice violations. Of course, even after designation, contract markets have a continuing obligation to comply with these requirements and the Commission monitors such compliance in the course of periodic rule enforcement reviews.

Staff believes that the NFA's projected TPMS staffing levels for handling regulatory services for the USFE during the initial stages of trading is acceptable, and that the NFA's contingency plans to increase TPMS staffing levels are reasonable.[67]

(d) The NFA's Ability to Monitor Trading Abuses in the Event of a Clearing Link

The CBOT commented that, if the USFE were to trade euro-denominated products that were fungible with products traded on Eurex via a clearing link, the USFE would not be able to meet its responsibilities through a delegation to the NFA, unless the NFA was able to access documents and records relating to relevant trades executed on Eurex and to conduct timely analysis of that trading data.

Staff notes again that the USFE has not submitted to the Commission as part of its application either proposed contracts or a proposed clearing link to Eurex. The NFA has stated, however, that it recognizes that a USFE-Eurex link for the trading and clearing of fungible contracts would require it to have greater access to information regarding Eurex positions. Accordingly, the NFA represents that it has agreed with the USFE that, before any link is implemented, a formal procedure must be in place for the NFA to have direct and prompt access to "necessary and appropriate information, including data relating to positions, trading and monies for any Eurex clearing firm, trader, and customer."[68]

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[67] The Commission has stated that in "using contractors to fulfill a self-regulatory function, it is the exchange's responsibility to ensure that its obligations under the Act are met." 66 Fed. Reg. 42256 (August 10, 2001). Hence, the USFE will ultimately be responsible for meeting the designation criteria and the core principles, including those that relate to matters contracted to the NFA.

[68] *See* NFA letter at 4.

(2) The NFA's Authority to Provide Regulatory Services to the USFE

The CME, in a footnote in its first comment letter, challenged the NFA's authority to provide regulatory services to the USFE. Specifically, the CME stated that the NFA, in amending its Articles of Incorporation (Articles) to permit it to provide regulatory services, did not contemplate providing wholesale regulatory services to an exchange like the USFE that competes directly with existing exchanges. The NFA responded to this comment in its letter to the Commission dated November 4, 2003. With respect to the amendment to the Articles, the NFA noted that its staff reviewed the materials related to the amendment, including Executive Committee and Board meeting minutes, and found nothing that indicated that the NFA could not offer its regulatory services to exchanges that compete with existing exchanges. The NFA stated that the history of the amendment indicated a deliberate attempt to broaden the NFA's authority.

The CME also commented that the NFA's Articles prohibited it from performing the regulatory functions for the USFE because, in so doing, the NFA was adopting, administering, and enforcing contract market rules. In its letter, the NFA pointed out that the RSA does not authorize the NFA to adopt, administer, or enforce any USFE rules. The NFA is under contract to perform a service, and would not make any decisions on behalf of the USFE.[69] Staff agrees with the NFA's analysis with respect to its Articles and, based upon its own analysis set forth below, believes that the services that the NFA has contracted to provide to the USFE do not appear to be outside of its corporate authority and thus do not constitute an *ultra vires* contract as the CME has suggested.

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[69] *See* discussion at pp. 68-72 (USFE/NFA relationship). The CBOT subsequently commented that the NFA would be involved in "monitoring trading" and questioned whether monitoring trading was exercising decision-making. The CBOT stated that it would seem logical that monitoring trading for trading abuses involves some decision-making. Staff agrees with the NFA's assertion, as stated in its letter of November 4, 2003, that the NFA is a contractual service provider and will not make any decisions on behalf of the USFE.

The NFA is a Delaware not-for-profit membership corporation that was formed in 1976. As part of the USFE's application to the Commission to be a DCM, the USFE submitted the RSA, through which it retains the NFA to perform certain trade practice and market surveillance services.[70]

An *ultra vires* contract is a contract entered into by a corporation that is not within the express or implied powers of the corporation. Whether a corporation exceeds its corporate powers is examined with reference to its articles of incorporation. A statement in a corporation's charter of its purposes has the practical effect of defining the scope of the authorized corporate enterprise or undertaking.

Article III of the NFA's Articles, which contains three sections, is a lengthy statement of the NFA's "purposes" that sets forth the areas in which the NFA may operate, as well as express limitations on the scope of the NFA's authority.[71] Whether the NFA has the power to provide the

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[70] *See* footnote 68 for a discussion regarding the level of responsibility that is applicable to DCMs when they contract out self-regulatory functions.

[71] NFA Article III provides, in pertinent part:

> **Section 1. Fundamental Purposes.**
>
> Subject to the limitations in Section 2 of this Article, the fundamental purposes of NFA are to promote the improvement of business conditions and the common business interests of persons engaged in commodity futures or related activity (i) undertaking the regulation of persons that are members of NFA (hereinafter "Members") as set forth in this Article; (ii) relieving the [CFTC] from the substantial burden of direct regulation in such matters; and (iii) providing such regulatory services to such markets as the Board may from time to time approve .
>
> * * *
>
> **Section 2. Contract Markets.**
>
> **(a) Non-applicability of NFA Rules.**
>
> No NFA requirement shall purport to govern or otherwise regulate the specific conduct of a Member or Associate if such conduct is governed or regulated by the requirements of a contract market and such Member or Associate is subject to the contract market's disciplinary jurisdiction for such conduct.
>
> **(b) Prohibition Upon Adoption of Certain Rules.**
>
> NFA shall not adopt, administer or enforce upon any Member or Associate a rule, standard, requirement or procedure which purports to govern or otherwise regulate any of the following:
>
> * * *

(continued)

regulatory services set forth in the RSA requires an interpretation of the scope of the NFA's powers set forth in Article III.

In Delaware, an interpretation of contract language, including the language of articles of incorporation, begins with resolving whether such language is ambiguous, from the perspective of the reasonable person. Where contract language is ambiguous, a court may consider extrinsic evidence offered in order to arrive at a proper interpretation of contractual terms. Extrinsic evidence that reveals the parties' intent at the time they entered into the contract is the only extrinsic evidence that is relevant.

(a) Article III, Section 1

In 2001, the NFA amended Article III, Section 1 to add to its stated purposes "providing such regulatory services to such markets as the Board may from time to time approve" (the regulatory services provision). The CME contended that the regulatory services that the NFA has contracted to provide the USFE are not within the scope of the regulatory services provision. Specifically, the CME argued that the intent of the regulatory services provision was to permit the NFA to provide regulatory services *only* to "evolving electronic exchanges and B2B exchanges that did not compete directly with existing exchanges."

In the staff's opinion, a reasonable person in the position of the NFA's incorporators could not read the amended language in the way that the CME maintained that it should be read. Other than the requirement concerning the NFA Board approval, Article III contains no express limitations on the types of markets to which the NFA may provide regulatory services. Because the language in controversy is not ambiguous, a court would likely find that there is no merit to

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(iv) The content, interpretation, administration or enforcement of any rule, standard, requirement or procedure of a contract market or clearing organization.

(v) The conduct of business or other activities on the trading floor of a contract market.

* * *

an argument based on Article III, Section 1 that the RSA is *ultra vires*. For this reason, it is not likely that a court would consider any extrinsic evidence of the NFA directors' intent in adopting the regulatory services provision.

(b) Article III, Section 2

The CME also contended that NFA Article III, Section 2(b) contains limitations on the NFA's powers that prevent it from providing regulatory services to the USFE. Staff believes, however, that the CME's interpretation of Article III, Section 2 is in contrast to what appears to be the general purpose of Section 2. Section 2(a) contains an express limitation on the NFA's ability to apply any NFA rules to conduct that is already governed by or regulated by a contract market. Section 2(b) further constrains the NFA's authority over contract market activities.

The plain language of Section 2(b) suggests that its general purpose is to limit the NFA from usurping the authority of contract markets to regulate certain activities. Given the scope of the RSA, it cannot be said that the NFA is usurping the authority of the USFE, or that the NFA is acting in conflict with the USFE. The USFE has merely entered into a contract with the NFA whereby the NFA will perform certain regulatory services for the USFE. In short, the USFE retains ultimate responsibility for determining how to administer or enforce its disciplinary rules. Because the NFA will not be acting in any way to diminish the USFE's authority to police itself, the RSA is not inconsistent with the general purpose of Section 2. Moreover, given that Section 2 was drafted decades before the NFA started providing regulatory services to exchanges, it is not likely that the NFA intended the limits contained in Section 2 to apply to the NFA's activities -- such as the RSA -- that did not in any way appropriate the authority of a contract market to regulate itself.

The most likely controversy that may arise would be whether the NFA, by providing regulatory services to the USFE, is "administer[ing] or enforc[ing] . . . . a rule, standard,

requirement or procedure," within the meaning of Section 2(b). To find that Section 2(b) prohibits the NFA from performing regulatory services for the USFE, however, would require a strained reading of the words "administer" and "enforce," in that those words indicate a degree of ultimate decision-making authority over the enforcement of the USFE's rules that does not exist in the RSA. Accordingly, it does not appear that the limitations in Section 2 prevent the NFA from providing the types of regulatory services as described in the RSA.

In any event, the ultimate issue here may need to be litigated in Delaware state court. However, the staff feels comfortable that the Commission has the legal authority to move forward in taking action upon the USFE application. It is worth noting that the NFA feels comfortable with its authority to undertake this regulatory services agreement with the USFE.[72] In conclusion, the staff believes that it is appropriate for the Commission to proceed in this designation.

(3) The NFA's Costs

The CME was concerned that costs associated with the NFA's performance of regulatory services would be borne in part by industry participants other than the USFE. That commenter sought an assurance that the NFA's costs for performing functions under the RSA would not be subsidized in any way by existing exchanges. The NFA's RSA with the USFE includes both fixed-fee and volume-based pricing terms. Staff is satisfied that in combination these pricing terms will allow the NFA to fully recover directly from the USFE all costs incurred pursuant to functions performed under the RSA.

[72] As previously noted, NFA has agreed to provide regulatory services for DCMs on four other occasions without any legal challenge.

c. Market Surveillance Issues

(1) Ability of the Commission to Review the USFE's Contracts Before They Are Listed

The CBOT and the CME commented that the USFE application describes a "plain vanilla" exchange with no futures or options contracts. These commenters further noted that, upon receiving contract market designation, the USFE will then self-certify the rules that implement its true business plan with no further review from the Commission or other interested parties. The commenters stated that, in the absence of contract specifications, it is not possible for the USFE to demonstrate its compliance with Core Principle 3. In addition, these commenters stated that an applicant for contract market designation is required to make information public pursuant to Designation Criterion 7 and Core Principle 7.[73] Specifically, it was stated that Core Principle 7 requires that a DCM applicant make available to the public, among other things, the terms and conditions of its contracts.

The CBOT and the CME are correct in noting that the USFE's application does not contain the terms and conditions of the contracts that it intends to list for trading. However, under the Act, as amended by the CFMA, it is not a prerequisite to designation as a contract market for an applicant to submit the terms and conditions of the contracts that it intends to list. In fact, four of the six exchanges that have been designated as contract markets since passage of the CFMA did not identify the contracts they intended to list while they were in an applicant status.

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[73] Designation Criterion 7 states that "The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade . . . ," and Core Principle 7 states that "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 major feature of the CFMA is the elimination of prescriptive rules and approval requirements for listing new products. In this regard, the CFMA established exchange self-certification procedures whereby exchanges can list new products without obtaining prior approval; exchanges must only notify the Commission one business day prior to listing the contract and include a certification that the contract complies with the requirements of the Act and Commission regulations. These procedures, which provide exchanges the flexibility to list contracts quickly to meet industry needs and competitive challenges, were widely supported by U.S. exchanges, including the CBOT and the CME. Exchanges have taken advantage of the new opportunities provided and have launched a record number of new products (348 new products were filed in fiscal year 2003, far surpassing the previous record of 92 new products filed in fiscal year 1996). Moreover, since certification procedures were adopted in 2000, over 90 percent of the new product filings by the CBOT and the CME have been via self-certification.

With respect to contracts filed by exchanges under certification procedures, staff conducts due diligence reviews of all such new contract filings to ensure that listed contracts comply with all applicable statutory requirements and Commission regulations and policies. These reviews address Core Principle 3, which provides that contract markets list contracts that are not readily susceptible to manipulation, and Core Principle 5, which requires DCMs to adopt speculative limits or position accountability where necessary and appropriate to reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month. If deficiencies are found, the Commission initiates discussions with the contract market to address the issues identified and may, if no resolution is forthcoming, initiate proceedings under the Act to change the contract market's rules or adopt speculative limits.

In addition, once contracts are listed for trading, the Commission's surveillance staff closely monitors trading activity in order to detect and prevent market manipulation and other forms of market abuse. Surveillance staff keeps in close contact with the exchanges when problems arise and appropriate action, which ranges from informal discussions with traders to emergency actions such as shutting down a market, is taken to deal with any manipulation threats.

With respect to the comment about making available to the public the terms and conditions of its contracts, the USFE states in its application that its bylaws, rules, and contract specifications, including the terms and conditions of all contracts and the mechanisms for executing transactions on or through the Trading System, will be posted on the Exchange's website. Staff views these representations as sufficient to demonstrate compliance with Designation Criterion 7 and Core Principle 7. In this regard, staff disagrees with the CBOT's assertion that applicants for designation are required by Designation Criterion 7, prior to designation as a contract market, to publish the terms and conditions of the contracts they intend to offer. Staff believes that, prior to designation, the designation criteria are intended to address a board of trade's *capacity* to perform certain functions, rather than imposing affirmative obligations. To read the designation criteria otherwise would require a board of trade to perform self-regulatory functions before any Commission approval or authorization to do so, thus rendering the designation process meaningless. Similarly, staff reads Core Principle 7 to require DCMs to make rules public following their approval by the Commission or their certification to the Commission.[74]

[74] *See* Commission Regulation 40.8.

(2) Need for Coordinated Surveillance for Fungible Products Listed on Both the USFE and Eurex

The CBOT indicated that that the USFE plans to list the same euro-denominated products based on German Treasury debt that currently are listed for trading on Eurex. The CBOT commented that it would be necessary to coordinate surveillance of trading on Eurex with trading on the USFE in order to assess any potential manipulative activity involving fungible euro-denominated products. The CBOT questioned which exchange would be responsible for any fungible euro-denominated contracts. Further, the CBOT asked, with respect to large trader reporting, when the same products are traded on Eurex and the USFE, whose reporting rules will apply and how will simultaneous positions on Eurex and the USFE be addressed.

As noted above, the USFE's application does not include the contracts that it intends to list for trading, as this is not a prerequisite to designation as a contract market. The USFE also has not formally submitted to the Commission any arrangements related to a clearing link. When the USFE submits its contracts and the details of a clearing link, staff will evaluate these filings for compliance with statutory requirements and Commission regulations and policies. If the USFE and Eurex propose to list commonly cleared, fungible products, staff will evaluate the details of such an arrangement and will ensure that this is done in accordance with Commission regulations and policies.

(3) Speculative Limits, Position Accountability and Hedge Exemptions

The CME commented that the USFE, in its application, does not incorporate or reference Commission Regulation 1.3(z)(1), the Commission's hedging definition, and that the USFE does not restrict speculative limit exemptions to hedge positions. The CME also indicated that the USFE ignores the Commission's standards for determining the types of accountability permissible for a particular contract.

As noted above, the USFE's application does not include the terms and conditions of the contracts that it intends to list for trading, as this is not a prerequisite to designation as a contract market. The USFE states that it intends initially to list for trading contracts on underlying commodities for which position accountability procedures are applicable. The USFE has indicated that, were it to list contracts for which speculative position limits are required, it would adopt limits. The USFE also states that any exemptions allowed, and the procedures for applying for an exemption, would be consistent with Commission regulations.

Moreover, it should be noted that, for contracts filed under certification procedures, the staff conducts due diligence reviews of all such new contract filings to ensure that listed contracts comply with all applicable statutory requirements and Commission regulations and policies, including Core Principle 5, which requires DCMs to adopt speculative limits or position accountability where necessary and appropriate to reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month. Accordingly, when the USFE submits its contracts, staff will evaluate the appropriateness of the speculative limit or position accountability provisions adopted for each contract, as well as the appropriateness of any exemptions from the speculative limits that may be provided. If any inconsistencies with the Act or the Commission's rules are found, staff will initiate discussions with the USFE to correct the inconsistencies, and may, if no resolution is forthcoming, initiate proceedings under the Act to change the USFE's rules as necessary.

d. Financial Integrity and Financial Surveillance Issues

(1) Guaranty Fund of C Corp

The CBOT argued that C Corp's plan to back the USFE trades through a guaranty fund, rather than the previous use of stock owned by clearing members, will subject customer funds to a significant risk in the event of a clearing member default. The CBOT notes that, pursuant to

C Corp's recent restructuring proposal, the minimum required guaranty fund deposit for sole proprietors is $75,000 and for other legal entities is $200,000. The commenter claims, however, that prior to the restructuring proposal, the minimum requirements were $166,280 for sole proprietors, and from $332,560 to $498,840 for other legal entities. As a result, the CBOT argues that the size of the guaranty fund has decreased significantly. Moreover, the commenter claims that customer funds are at a greater risk because C Corp will no longer have pledged seats from members as a backup resource in the event of a clearing member default.

Staff notes that C Corp is a registered DCO and is subject to direct Commission oversight. As a registered DCO, C Corp is required to demonstrate to the Commission that it complies with the core principles for DCO registration. The core principles provide a DCO with flexibility in determining how to satisfy the core principles, including how to demonstrate to the Commission that it has adequate financial resources to discharge its DCO responsibilities. C Corp's guaranty fund requirements will be determined for each clearing member based upon the volume and risk associated with such clearing member's cleared futures and option positions. Staff has discussed with representatives of C Corp the size of its Guaranty Fund and the methodology for determining member contributions. Staff believes that the size of the Fund and the methodology for making adjustments are reasonable for the markets involved. Furthermore, as part of the Commission's oversight process, DCOs are periodically subjected to oversight examinations for the purpose of determining each DCO's compliance with the core principles. In performing such examinations, staff will independently review C Corp's quantitative analysis of the necessary level of resources.

(2) Plan for Routine Financial Surveillance

The CBOT commented that the USFE application does not sufficiently describe a plan to govern the review of the financial condition of its members on an ongoing basis through routine

financial surveillance. In particular, the CBOT believes that C Corp does not currently have the technology on par with industry standards to receive electronic filings of financial statements, nor to perform automated financial statement analysis; and notes that it is unclear whether C Corp or the NFA will review daily financial filings that may be required to effectively monitor high risk firms or review large trader information in the context of financial surveillance. The commenter also questions whether the USFE plans to participate in the Joint Audit Committee (JAC) and the Joint Audit Plan, and whether the NFA possesses the necessary resources and expertise to conduct financial examinations.

Staff notes that the USFE has contracted with the NFA and C Corp to provide financial surveillance services with respect to USFE member firms. As part of these arrangements, the NFA will conduct various programs, including: (1) a background check, financial analysis and risk analysis of each applicant for membership; (2) on-going financial analysis of the USFE members; and (3) on-going risk analysis of the USFE members. The application review will include a review of any disciplinary information provided by US and foreign regulators, financial information provided to the USFE by the applicant, and a risk analysis interview that will allow the NFA to obtain an understanding of a firm's operations, trading activity and risk management practices. Once a firm becomes a member, it will be required to submit financial information to the NFA via Winjammer (for those firms that are members of the NFA) or, where necessary, the NFA's InFast system. These systems will review the financial information against certain parameters, and will produce alerts should any financial issues arise. The NFA also will review a member's pay/collect information on a daily basis as compared to its adjusted net capital, as well as any large trader information, and conduct stress tests for large market moves using C Corp's risk reports. The USFE will receive and review any reports generated by the NFA. Prior

to commencing operations, the USFE intends to appoint a full-time risk manager who will have direct responsibility for overseeing the financial surveillance activities of the NFA.

C Corp also will participate in the USFE's financial surveillance activities. Each morning, C Corp will verify that all final settlements and margin calls have been met; review various Rank reports (*e.g.*, margin deficits, change in margin on deposits, etc.); review, among other things, the system for sharing financial information among clearing organizations (known as SHAMIS) for deficits and pays at other clearing organizations; and create various risk monitoring reports (*e.g.*, SPAN array verification, Daily Risk, Margin Deficit, etc.). Throughout each trading day, C Corp will monitor the Net Debit Cap (NDC) system and contact participants and settlement banks, as necessary. To address counterparty risk, C Corp will review daily settlement and margin deficits and the parental guaranty reports.

The NFA, the USFE and C Corp have instituted regular meetings to coordinate procedures, processes and systems, and to discuss any issues of concern relating to financial surveillance. C Corp and the NFA also have agreed to share financial information, including, large trader stress-testing data, email alerts for the NDC system, clearing participant financial information and clearing participant audit results from the JAC. Staff further notes that the USFE recently has become a member of the JAC and plans to comply with all aspects of the Joint Audit Plan.

Staff also notes that C Corp will conduct routine financial surveillance of all clearing members. C Corp Rule 204 requires each clearing member to submit a statement of financial condition at such times and in such a manner as prescribed by C Corp. C Corp Rule 207 requires each clearing member to immediately notify C Corp, orally and in writing, of: (1) any material adverse change in the member's financial condition including, but not limited to, a decline in net

capital or, with respect to members that are not FCMs, net worth equal to 20% or more, or if such member knows or has reason to believe that its adjusted net capital has fallen below C Corp's minimum capital requirements; or (2) any proposed material reduction (and in all cases, if the reduction is 30% or more) in the member's operating capital, including the occurrence of a contingent liability that materially affects the member's capital.

(3) The NFA/CFTC Access to Necessary Financial Information

The CBOT stated that the NFA and the CFTC will not be able to obtain sufficient information from the USFE, Eurex or Eurex Clearing AG for the purpose of conducting market, trade practice, financial or sales practice surveillance.

Staff notes that the NFA performed a detailed review of the USFE's proposed compliance rules to ensure that the NFA would have the authority to obtain information from the USFE members and their customers. The NFA concluded that the USFE's rules – and the NFA's ability to obtain information – are practically identical to those for other U.S. DCMs. USFE Rules 307(g) and 308(h) require members to furnish information requested by the USFE or any of its agents, including the NFA. USFE Rule 309 states that it is a violation of the USFE rules for a member to fail to comply with a request for information by an entity authorized to conduct market, trade practice, financial or sales practice surveillance, in this case, the NFA. With respect to non-members of the USFE who trade on the Exchange, USFE Rule 616 authorizes the Exchange to order non-members to produce information and documents, subject to a penalty of having their positions liquidated for noncompliance.

Staff further recognizes that the NFA may need access to certain information regarding contracts traded on Eurex in the absence of a clearing link. Staff notes that the NFA can obtain that information directly from the USFE members carrying those positions and indirectly from

the USFE. The NFA has represented further that, before any clearing link arrangement is implemented, it will enter into a formal arrangement with the USFE, Eurex and Eurex Clearing AG to provide direct and prompt access to all necessary and appropriate information, including data relating to positions, trading and monies for any Eurex Clearing member, trader or customer.

e. Clearing and Clearing Link Issues

(1) Trades Will Be Cleared by a Non-DCO

The CBOT and the CME commented that any proposed clearing link violates Designation Criterion 5 and Core Principle 11 because certain trades executed on the USFE could be cleared by Eurex Clearing AG, an entity not registered with the CFTC as a DCO. Both the CBOT and the CME asserted that the clearing link is part of the USFE's business plan and should be included in the designation application. Staff notes that the USFE DCM application represents that all transactions executed on the USFE will be cleared and settled through C Corp, a registered DCO.[75] Any plans to establish such a clearing link will be subject to a separate, comprehensive review of all relevant legal and public policy issues. Moreover, both the USFE and C Corp have agreed to submit any such clearing link to the Commission for approval or permission.[76]

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[75] The USFE has, subject to a petition for confidential treatment, submitted its Clearing Services Agreement with C Corp to the Commission as part of its application and the Clearing Services Agreement has been reviewed by Commission staff.

[76] *See* Section VIII below.

(2) Rules Relating to Capital Adequacy, Treatment of Customer Funds, Margin Policies, Trade Cancellations and Default Procedures

The CME stated that the USFE rules do not appropriately address the capital adequacy of the USFE members, the treatment of customer funds, margin policies, trade cancellations and default procedures.

First, the CME contended that USFE Rules 302 and 307 only vaguely sketch the minimum financial requirements for USFE members and do not appear to specify any requirements for any clearing firms trading solely for their own accounts (and thus not required to register with the CFTC). Staff notes that USFE Rule 302 requires each member to have adequate financial resources and credit, and to be registered, licensed or otherwise permitted by the relevant government authority to trade on the USFE. USFE Rule 307 further requires all members that are FCMs and introducing brokers (IB) to comply with the CFTC's minimum financial requirements, and for members that are Securities and Exchange Commission (SEC) broker-dealers to comply with the minimum financial requirements set forth in the securities laws. In addition, staff notes that, as part of a petition for Regulation 30.10 relief, the Commission determined that the minimum capital requirements applicable to German firms acting in the capacity of an FCM are generally comparable to U.S. requirements. Clearing firms trading solely for their own accounts will be subject to C Corp's minimum financial requirements.

Second, the CME contended that USFE Rule 307 does not refer to or incorporate specific CFTC Regulations that apply to the protection of customer funds, nor does it provide any guidance as to the types of funds that may or may not be segregated. Staff notes that USFE Rule 307 requires each USFE clearing member to establish separate accounts for the purpose of maintaining customer funds in accordance with applicable law, including Section 4d(a)(2) of the

Act, and that USFE Rule 307 imposes a duty on the USFE members to notify the USFE immediately should a member fail to maintain segregated funds as required by law.

Third, the commenter contended that the USFE rules are silent with respect to many aspects regarding margin policy. Staff notes that USFE Rule 506 requires each member to collect margin from its customers in an amount not less than required by C Corp. If a customer account is not associated with a commercial activity within the meaning of CFTC Rule 17.01(d), the member shall collect not less than 130% of the amount that would otherwise apply. Each member also must collect from its customers additional margin in an amount and at such time as the USFE may from time to time determine.

Staff further notes that C Corp rules address margin policy. C Corp uses the SPAN system, the industry standard in the U.S. for margining futures and option positions. C Corp also has experience with the SPAN system, as it is the margining system it currently uses, and had used for many years to clear CBOT positions. In addition, C Corp Rule 405 provides that a member must pay original margin in U.S. dollars or any foreign currency deemed acceptable by C Corp. C Corp Rule 406 states that, in lieu of maintaining original margin in cash, members may deposit such types of collateral as may be approved by C Corp's Risk Committee or by the President. C Corp Rule 308 states that variation margin payments shall result in an immediate credit to the account of C Corp at the settlement bank. Furthermore, C Corp will make available to members SPAN arrays (including margin intervals and spread credits) to permit such members to calculate margin requirements.

Fourth, the CME contended that USFE Rule 405 creates an inefficient mechanism for the notification of a trade cancellation. Specifically, the CME noted that Rule 405 requires the USFE to immediately notify a member of the matching of bids and offers through the Trading

System and that objections should be filed with the USFE no later than the beginning of trading on the next business day. As such, a customer could "receive a fill confirmation immediately following the trade execution, only to learn the following business day that the trade was cancelled because the counterparty's clearing member has objected to the trade." The commenter further notes that Rule 405 "does not set forth the specific (or even general) circumstances under which an order may be challenged."

Staff notes that Rule 405 states that any trade confirmation issued by the USFE to a member "shall include all material details of the transaction." Further, a member is required to file any objections to the "contents of the transaction confirmations" with the USFE "promptly upon receipt, but no later than beginning of trading" on the next business day. As expressly stated in Rule 405, the grounds for any objection would refer to one or more of the material terms of the transaction. Furthermore, given that a USFE member will be liable to C Corp (or for non-clearing members, the clearing member with which it has executed a clearing guarantee) for any original and variation margins attributable to an incorrect trade confirmation, each USFE member has the incentive to file any objections as soon as possible. Staff notes further that, pursuant to the Clearing Services Agreement entered into by the USFE and C Corp, the USFE is required to provide electronically to C Corp the following information upon matching the trade: (1) the buyer and seller, together with their respective clearing members; (2) the specific contract; (3) the quantity; (4) the price or premium (and strike price if applicable); (5) origin code; and (6) any such information that C Corp requires. Based upon this information, C Corp will be able to determine promptly, via its electronic clearing system, whether a trade is to be cancelled for any reason, and if so, to notify the USFE that the trade has been rejected. As such,

the possibility that a customer would not learn of any cancellation until just prior to the commencement of trading on the next business day should be very remote.

Fifth, the CME contended that the USFE rules fail to address adequately the appropriate treatment of customer collateral and margin in the event of a default by a USFE member. Staff notes that C Corp rules, which have been previously reviewed by Commission staff, address the treatment of customer collateral and margin in the event of a default by a USFE member. The application of those rules is subject to review in the context of reviewing C Corp's compliance with DCO Core Principle 6.

(3) Performance Bond Reductions

The CBOT argued that the USFE's plans to provide 95% performance bond reductions on spreads between U.S. Treasury futures and German Sovereign Debt futures (Treasury-GSD spreads) would put C Corp at a risk of being under-reserved. The commenter believed that the price dynamics of these instruments are not highly enough correlated to warrant such a reduction. Staff notes that there is nothing in the USFE application that refers to such a performance bond reduction plan. Staff further notes that the CFTC would retain the right to review such a plan when and if it is submitted to determine whether it satisfies the core principles applicable to DCOs.

(4) Money Laundering

The CBOT argued that the use of a clearing link to offset fungible positions between Eurex and the USFE presents an opportunity for money laundering. For example, the commenter suggested the possibility that illicitly-obtained money is generated outside the U.S.; the funds are used to open a futures account to trade products on Eurex; the position is then transferred to C Corp and then liquidated on the USFE. As a result, illicitly-obtained money has been laundered and is now in the U.S.

As stated previously, staff notes that the USFE application represents that all transactions executed on the USFE will be cleared and settled through C Corp, a registered DCO. Any plans to establish a clearing link will be subject to a separate, comprehensive review of all relevant legal and public policy issues, including the extent to which money-laundering could occur. In addition, the NFA represents that it has agreed with the USFE that, before any link is implemented, a formal procedure must be in place for the NFA to have direct and prompt access to "necessary and appropriate information, including data relating to positions, trading and monies for any Eurex clearing firm, trader, and customer."[77]

Staff also notes that the German Money Laundering Act (Geldwaschegesetz, GwG) contains provisions to minimize the risk of money laundering. The BaFin is the responsible authority in this area. On March 30, 1998, the BaFin issued guidelines concerning measures to be taken by credit institutions to combat and prevent money laundering. Financial services institutions that are not credit institutions are also expected to observe these guidelines. The German Money Laundering Act also deals with ways to inhibit terrorist financing. Under the German Money Laundering Act, financial institutions (credit institutions, financial services institutions and certain other institutions) are required to identify clients if they accept assets or securities with a value of 15,000 euros or more. Financial institutions are required to report suspicious cases to the prosecuting authorities without delay. The German Federal Investigations Office for Criminal Matters has established a Financial Intelligence Unit to collect and process reports of suspicious cases. In addition, Germany, like the United States, is a member of the Financial Action Task Force (FATF), an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money

[77] *See* NFA Letter at 4.

laundering and terrorist financing. All member countries are monitored by FATF with respect to their implementation of FATF's Forty Recommendations setting out a framework for anti-money laundering efforts, and its Eight Special Recommendations containing international standards for combating terrorist financing.

(5) Jurisdiction Over Non-DCO Clearing Members

The CBOT argued that if trades executed on the USFE were cleared at Eurex Clearing AG via a clearing link, the NFA would not be able to obtain information and documents from Eurex Clearing AG and Eurex Clearing AG members. As stated previously, staff notes that the USFE application represents that all transactions executed on the USFE will be cleared and settled through C Corp, a registered DCO. Any plans to establish a clearing link will be subject to a separate, comprehensive review of all relevant legal and public policy issues, including the access to relevant market and other financial information. In addition, the NFA has represented that it has agreed with the USFE that, before any link is implemented, a formal procedure must be in place for the NFA to have direct and prompt access to "necessary and appropriate information, including data relating to positions, trading and monies for any Eurex clearing firm, trader, and customer."[78]

f. Trading, Membership and Operational Issues

(1) The USFE and the "Call Around" Market

The CBOT and DRW commented that currently Eurex option trading relies primarily on a "call around" market, resulting in OTC trading of a vast majority of options transactions through Eurex's alternative execution facilities. It was further stated that it is likely that the USFE option markets will be operated in the same manner. The CBOT also stated that the USFE

[78] *Id*.

in its application does not address its capability to self-regulate such a market, and that the application does not reveal that either the USFE or its delegates has the resources and expertise to police a far-flung telephone network of dealing activity conducted under the auspices of the Exchange. The CBOT concluded that, in the absence of evidence that the USFE could perform the required self-regulatory functions for options trading, statutory standards preclude the USFE from offering options trading on its exchange. In addition, DRW stated that the call-around market creates a form of "payment for order flow" that results in a fragmented market, late trade reporting, and broker conflict of interest. Finally, DRW stated that block trading is the primary enabling factor in the call-around market and internalization of orders, and should be prohibited.[79]

Commission staff has reviewed these comments and has contacted Eurex officials as well as cash market traders to gain a better understanding of the call around market. Based on this research, staff notes that the commenters are correct in stating that the overwhelming majority of Eurex option volume is generated away from Eurex's central marketplace, through block trades that have been negotiated in the OTC market. In Europe, this OTC option market is referred to as the call around market because a customer or broker typically "calls around" to obtain quotes from several different market makers in order to find the best deal. The bid/ask spread in this well developed OTC market generally is tighter than the bid/ask spread on the Eurex trading system. Once a transaction is made, it is booked on Eurex as a block trade and is then cleared by

[79] One commenter expressed concerns about whether any internalization of order flow will have a detrimental effect upon supply and demand in commodities of limited supply upon which the USFE may list futures contracts. The commenter asserted that "the relation of supply and demand in a physical commodity market is vastly different from that of a money based market." USFE officials have indicated that the Exchange plans to trade futures and options on U.S. and foreign government debt; thus, the commenter's concern relating to effects on physical commodity markets are not relevant. Moreover, no information was provided indicating how any internalization of order flow is related to supply and demand for a commodity.

Eurex Clearing AG. This existing process where option trades in Europe are negotiated bilaterally away from the centralized market and then booked on the Eurex market is analogous to the types of off-centralized-market trades that are commonly allowed by U.S. exchanges for their listed contracts.

Staff understands that the option market in Europe has developed in this way for several reasons. Option traders often employ complex strategies but the exchanges' trading systems do not have the functionality to handle the vast majority of these trades. In this regard, the Eurex trading system currently recognizes only seven simple two-legged types of option strategies. Traders thus have found it to be much easier to effect complex option trades over the phone. Eurex has set a minimum block trade threshold of 50 contracts to facilitate the transfer of these complex option trades to Eurex for clearing.

The USFE officials have stated that it is very unlikely that a variant of the European call around market would be replicated in the U.S. The Exchange is proposing three measures that are designed to facilitate option trading on its Trading System and to discourage off-market trades and the internalization of orders. First, as previously discussed, the USFE will introduce a new Options Strategy Board that will accommodate 45 predetermined types of option and option/futures strategies (compared to the seven strategies recognized by Eurex and the a/c/e platform used by the CBOT for the past several years). This should make it easier to execute complex trades on the central marketplace and lessen the need for personal contacts to negotiate customized terms.[80] Second, the USFE has indicated that it plans to set the minimum block trade

[80] The CBOT commented that the USFE "cannot expect anyone seriously to believe that with the flip of a switch Eurex has solved the technological problem of electronic [option] trading." Staff cannot predict whether the USFE's new Options Strategy Board will prove to be acceptable to traders in executing complex option trades. Rightfully, this can only be decided by market participants. Finally, the CBOT's contention that the Options Strategy Board is doomed to failure and thus the USFE "will undoubtedly have to offer a stealth call around market" is without merit. (continued)

threshold at 1,500 contracts for the U.S. Treasury bond contract and 2,500 contracts for the U.S. Treasury note contracts it is likely to introduce first – these levels are either 30 or 50 times greater than the 50-contract minimum set by Eurex for its German government debt contracts. Third, the USFE proposes to have permanent market makers, which should facilitate the matching of traders wishing to execute complex option trades.

However, staff notes that, even if there were some option trades that are executed in the OTC market and pursuant to the USFE rules then booked on the Exchange via the block trading facility, this would not necessarily violate any provision of the Act or the Commission's rules or policies. Several types of off-centralized-market trading are permitted by the Act and Commission regulations.[81] These include EFPs, which have been allowed in the U.S. since 1936 and currently are permitted by all U.S. exchanges,[82] and block trading, which has been allowed on U.S. futures exchanges since 2000.[83] The staff does not believe that such off-centralized-market trading necessarily leads to less transparent market prices, greater market fragmentation or customer abuses. The USFE, like all existing U.S. exchanges, must comply, on an ongoing basis, with the designation criteria and core principles, and must enforce all Exchange rules setting forth requirements and obligations related to eligibility, execution, reporting and record keeping. These requirements and obligations are designed to ensure the financial and market integrity of U.S. futures exchanges.

As discussed herein, exchanges must enforce their rules related to permissible off-centralized-market trading, and the Commission has adequate tools to oversee the exchanges and trading activity on their markets to detect and prevent abuses.

[81] As noted earlier, the other types of off-centralized-market trading that would be permitted under the USFE's rules are EFPs, EFSs and Vola trades.

[82] In this regard, EFPs sometimes constitute a large proportion of overall activity (*e.g.*, as much as 90 percent of trading in some CME currency contracts).

[83] Block trading also may constitute a large proportion of overall activity (*e.g.*, as much as 38 percent of monthly trading on the BTEX in 2003).

The Commission's staff continually surveils all markets to detect market manipulations and performs periodic trade practice investigations and rule enforcement reviews to ensure that all U.S. exchanges are enforcing their rules, including any rules related to permissible off-centralized-market trading, and complying with the core principles. The staff believes that these Commission tools are adequate to oversee the exchanges and trading activity on the markets and to detect and prevent abuses in connection with off-centralized-market transactions.[84]

Finally, staff notes that providing for the clearing of OTC trades on a DCO was contemplated by the CFMA. Any such off-centralized-market execution of the USFE contracts would be subject to the USFE recordkeeping requirements. Such an arrangement would be almost identical to the CFTC-approved NYMEX practice of clearing OTC natural gas trades that are executed bilaterally in the OTC market, where the contract terms are set by the NYMEX and the trades are executed in the OTC market and then transferred to the NYMEX for clearing.

(2) Volume Discount Programs

The CME, the CBOT, DRW and certain other commenters, raised concerns about the USFE's anticipated implementation of "payment for order flow" programs. The commenters particularly referenced the USFE marketing materials that briefly outline a "Top Ten" revenue rebate and incentive program for U.S. Treasury derivative products. The commenters raised two primary concerns. First, they are concerned that the USFE programs will encourage brokers to blindly funnel orders to the USFE in violation of a broker's fiduciary duty. Second, the commenters believe that the USFE-sponsored programs may create significant incentives for market participants to engage in fictitious and other forms of non-competitive trading in order to generate volume.

[84] Staff notes that all off-centralized-market transactions in USFE contracts would be executed pursuant to the USFE's rules and would be subject to, among other requirements, the prohibitions of Sections 4b and 4c of the Act.

The term "payment for order flow" is more commonly used to describe incentives offered by securities exchanges or market makers to securities brokers to direct orders to a particular exchange or an OTC dealer.[85] Staff generally views these plans as volume discount programs because their primary purpose is to enhance volume by discounting transaction fees. Neither the Act, nor the Commission's regulations, prevents exchanges and market participants from adopting discount programs.

Futures exchanges have consistently offered reduced fees and other economic incentives to market makers, brokers and traders, including plans that are substantially similar to the referenced "Top Ten" program,[86] in order to attract volume to particular products.[87] Staff's regulatory analysis of exchange sponsored incentive programs focuses on the manner of implementation and the potential for distorting open, competitive, and efficient trading by facilitating illegal trading practices, such as wash or fictitious trading. DCMs are obligated by Core Principle 2 to monitor trading for trade practice abuses.[88]

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[85] Academics argue that payment for order flow creates potential problems in the securities markets in part because of the level of market fragmentation and difficulties in identifying and quantifying transaction costs. *See* Allen Ferrell, *A Proposal for Solving the "Payment for Order Flow" Problem*, 74 S. Cal. L. Rev. 1027 (2001). In contrast, futures and options trading in specific commodities has typically been concentrated on one or a limited number of DCMs with highly transparent fee and transaction cost structures.

[86] *See, e.g.*, CME Incentive Program for Agency Futures Trading (March 2000); NYMEX ClearPort Incentive Plan (February 17, 2003); CME Euro FX and Euro FX Cross-Rate Incentive Program (April 1999). Staff notes that there is no provision in the USFE's formal application that would establish a volume discount program like the "Top Ten" program described by the commenters. The RCAs, previously discussed in Section VI above, do offer trading incentives, but the RCAs do not in any manner resemble the "Top Ten" programs.

[87] *See*, *e.g.*, CBOT Modified Market Maker Program for the Wilshire Small Cap Index Futures Contract (June 18, 1993); CME Principal Market Maker Program (April 20, 1995); NYMEX Specialist Market Maker Program (July 8, 1998); CBOT a/c/e Temporary Fee Waiver Program Extension (March 25, 2003).

[88] One commenter, an academic, stated that one scenario that may unfold as the USFE attempts to capture market share is a race to the bottom for exchange fees, where each market matches fee cuts by other markets with the result that market surveillance funding will become a casualty. He stated that the Commission needs to take precautions to safeguard the market surveillance function of markets. Staff believes that the Commission already addresses this issue. Commission staff evaluates the capability and performance of each DCM's market surveillance function approximately once every two years during the course of rule enforcement reviews to ensure that the DCM remains in compliance with, among other things, Core Principle 4, which address market surveillance issues. Where (continued)

Staff also analyzes a plan's potential for eroding fiduciary obligations owed by futures brokers to customers. Core Principle 12 requires that DCMs establish and enforce rules that protect market participants from abusive trading practices committed by any party acting as an agent for a participant, and in a situation where a broker handles an order that could be executed at more than one exchange, Commission staff would want to ensure that an incentive plan does not compromise the broker's fiduciary obligations.[89]

In addition to the comments on anticipated USFE-sponsored incentive programs, certain other commenters, and in particular DRW, based upon its experience with Eurex, perceived payment for order flow problems related to the USFE's cross and block trading rules. DRW raised the possibility that brokers handling cross and block transactions may seek to extract payment from market makers for the privilege of being the counterparty to the broker-held order. DRW attributed this potentiality to the decreased level of transparency associated with such transactions, and to the ability of brokers to take customer orders to multiple sources. With respect to USFE's cross trading rule,[90] staff believes that certain safeguards, such as requiring customers to give consent to the cross and members to give priority to customer orders, effectively minimize the likelihood that cross trades will be used as a mechanism for illegal pre-arrangement and facilitating payment for order flow. With regard to block trading, the USFE has established participant limitations that should help to ensure that only market participants that are capable of monitoring the quality of brokerage services offered have access to such customized

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appropriate, the staff makes recommendations that would assist the DCM in maintaining a market surveillance function that would continue to meet the requisite standards.

[89] The USFE has agreed to submit any non-traditional form of incentive program to the Commission for review one month in advance of the program's proposed effective date. *See* Section VIII below.

[90] USFE Rule 406.

transactions.[91] Finally, the USFE rules restricting pre-negotiation and the withholding of orders,[92] and the USFE's responsibility to implement an appropriate ongoing trading oversight program, all minimize the potential that cross and block trading will be used to facilitate improper volume discount practices.

(3) Duties of Members

(a) USFE Rule 307(d) (Commission Recordkeeping Requirements)

The CME commented that USFE Rule 307(d), in "vaguely mentioning" that members must maintain "records showing the details and terms of all transactions in all contracts," fails to specify the types of records members are required to maintain and that such failure is likely to hamper the Exchange's ability to use such information to prevent and detect market and customer abuses.

USFE Rule 307(d) requires that each member keep a record, as the Commission may direct, showing the details and terms of all contracts and related cash transactions entered into or carried by the member. Thus both Rule 307 and Commission regulations address the obligations of Exchange members and FCMs to keep full and complete records of all transactions executed on the USFE. The types of records to be maintained are specified in the User Guide and include for each order, among other things, whether the order is to buy or sell, contract identification, quantity, price (limit orders), expiration of order, CTI code, and customer account number. All details of every trade are captured in a comprehensive electronic audit trail.[93] Staff believes that

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[91] In this regard, USFE Rule 415 only allows members to engage in block trading on behalf of customers that are eligible contract participants (*see* Section 1a(12) of the Act) or are regulated and well capitalized advisers with substantial fiduciary and regulatory responsibilities to their own customers (*See* Commission Regulation 4.34).

[92] *See* USFE Rules 307(m) and (n), 308(k) and (o), and 406.

[93] Further, USFE Rule 308 prohibits members from violating or failing to conform to applicable provisions of the Act, Commission regulations, or any other law applicable to trading on the USFE.

the USFE's recordkeeping procedures are fully compliant with Core Principle 10 and will provide the Exchange and the NFA with adequate information to prevent and detect customer and market abuses.

(b) USFE Rule 307(j) (Contracts Entered under ID)

The CME commented that the USFE rules do not appear to require terminal operators to enter an ID or an account number into the Trading System prior to entering an order. Such a deficiency would make it difficult to conduct audit trail analyses to decipher improper conduct.

Technical details of order entry are specified in the User Guide, and need not be restated in the Exchange's rules. It is clear from the User Guide that the Trading System captures and associates with each order an identifier for each individual workstation through which an order can be entered and, thus, it is possible to identify the workstation from which the request came and the individual trader who initiated the request. Likewise, it is not possible to enter an order into the Trading System without a CTI code and an account identifier. Thus, staff believes that the USFE's order entry procedures are consistent with Core Principle 10.

(c) USFE Rule 307(n) (Priority of Customer Order Entry)

The CME commented that USFE Rule 307(n) appears to allow a member that receives a customer order to ask or instruct a terminal operator to enter a third-party order into the Trading System, provided that neither the terminal operator nor the third party are aware of the customer order. This, according to the CME, permits the potential withholding and frontrunning of customer orders.

USFE Rule 307(m) requires that members exercise due diligence in the handling of customer orders. USFE Rule 307(n) requires that customer orders be given priority of entry. In addition, Rule 308 prohibits members from engaging in: (1) conduct that violates Commission

regulations, any other applicable law, or the rules of the Exchange or C Corp; or (2) conduct that is inconsistent with just and equitable principles of trade, or detrimental to the best interests of the Exchange. In addition, customers are protected not only by Exchange rules, but also by established principles of agency law. For example, under agency law, a member could be liable for front running whether it acted directly or through the actions of its agent or employee. Staff believes that well-established principles of agency law, combined with the USFE's comprehensive audit trail and recordkeeping requirements, and the investigatory authority of the Exchange and the NFA, provide sufficient safeguards against the withholding and front-running of customer orders.

(4) Trading Rules

(a) USFE Rule 401 (Business Day Periods)

The CME commented that Rule 401, Business Day Periods, uses the terms "orders" and "quotes," which are not defined in the rules and, thus, the application of the rule is unclear. The CME further commented that in Rule 403, Orders, the term orders appears to refer both to orders and quotes. Staff does not believe that Rule 401 is either defective or confusing. Rule 403(a)(i) provides that, except as otherwise expressly provided in the rules, all transactions of any type in or involving contracts must be transacted through the Trading System, which is a defined term. Orders and quotes are driven by the Trading System's interactive windows and are thereby defined.

Orders and quotes are handled identically in the Trading System and are identifiable based largely upon how and by whom they are entered into the Trading System. Quotes that are entered with two sides (priced bid and priced offer) in one system transaction can only be entered by market makers. Quotes are handled like limit orders in that each bid or offer is queued in the order book in price-time priority with other quote-based or order-based bids and offers. Each

market maker's quote updates (removes and replaces) any quote that he or she has in the system (*i.e.*, market makers can only have one live quote on each side of the market at any time). Quotes are good for the current trading day only, although the system retains any quotes as a convenience to the market maker who can review them and reinstate them automatically.

Orders are one-sided and can be entered for either the principal or customer accounts. Orders can be entered by market makers or authorized traders. Order types currently available in the Trading System would include market orders, limit orders, combination orders, and, for futures, stop orders. Depending upon the type of order, an order may remain valid, among other time periods, until the end of the trading day, until withdrawn, or for a certain period. If not transacted, orders must be cancelled, either manually or automatically as a result of time-expiration of the order, to be removed from the order book. Finally, an authorized trader, as well as other traders in the same trader subgroup, can have multiple live orders in a contract.

(b) USFE Rule 403(e) (Average Price Trades)

The CME commented that USFE Rule 403(e) fails to prescribe the audit trail requirements for average price confirmations and does not require customer consent or prohibit the bunching of customer and proprietary trades in the calculation group.

Staff believes that these issues are addressed adequately in the Exchange's rules. USFE Rule 403(e)(i) precludes a member from placing or confirming an order or series of orders at different prices using an average price method that is not in compliance with current Commission requirements. USFE Rule 307 requires that the member comply with Commission reporting and recordkeeping requirements.

(c) USFE Rule 415 (Block Trades)

The CME and the CBOT both commented that USFE Rule 415 governing block transactions lacks a "fair and reasonable" pricing requirement and does not specify either what or how block transaction details will be publicized by the Exchange.

Staff notes that, although there are "fair and reasonable" pricing requirements in many Commission-approved block trade rules, the Commission has approved a block trade rule at the BTEX that did not include any transaction price standard.[94] In addition, the Commission did not include any pricing standards for block transactions in its Part 38 Application Guidance for Core Principle 9. Accordingly, staff does not believe that it is necessary for the USFE to adopt a "fair and reasonable" pricing requirement for its block trade rule. Staff notes that, although USFE Rule 415 does not specify that block trades be at a "fair and reasonable price," the rule does require that block trades be priced no more than five ticks outside the range of the day's high and low for the subject contract at the time they are executed.[95]

The USFE has revised Rule 415 and made representations that make clear that block trade information will be posted on the Trading System's online time and sales register immediately after a trade has been executed and submitted to the Exchange. Block trade postings would identify the trade as a block trade and would include the product, quantity and price. The USFE also has clarified that while block trades would be negotiated off of the Exchange's central marketplace, they would be executed entirely through the Trading System's block trade facility. Specifically, after negotiations the prospective buyer would enter the details of a block trade through the block trade facility, the prospective seller would be alerted and could

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[94] *See* BTEX Rule 406. BTEX suspended its trading operations as of the close of business on November 26, 2003.

[95] The CBOT in its third comment letter contended that Rule 415 was vague as to how the daily high and low requirement would be applied in this context. The USFE has clarified that the day's high and low for these purposes means the high and the low prices for that contract up until the time of the block transaction.

then retrieve the trade details from the system for review.[96] The block trade would be considered executed at the time that the seller confirmed the details of the transaction on the Trading System. The Exchange would be required, under Rule 415(h), to post the details of each block transaction on the Trading System's time and sales report immediately after notification. Accordingly, the time between a block trade's execution and its publication would be extremely short. Based upon this understanding of the USFE's block trading procedures, staff believes that the USFE's method of block trade reporting and publication is comparable to procedures that the Commission has approved at other DCMs and is consistent with the requirement, under Core Principle 9, that DCMs provide a "competitive, open and efficient market and mechanism for executing transactions."

The CBOT in its second comment letter contended that parties to USFE block trades would gain an informational advantage and be able to trade on the basis of that information prior to the block trades being announced to the market. The CBOT further commented that allowing this sort of informational advantage to occur at the USFE would ultimately compromise the integrity of the CBOT's markets to the extent that the USFE "clones" the CBOT's Treasury security contracts.[97] Even presuming that the USFE does trade clones of the CBOT contracts,

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[96] Details of the transaction would only remain on the Trading System for the seller to confirm for 15 minutes after entry by the buyer.

[97] The CBOT in its third comment letter contended that the informational advantage for the USFE block trade participants is particularly extraordinary because: (1) they will have up to 15 minutes to report block trades after execution, and (2) the USFE will be publicizing block transaction details "promptly" after notification, instead of "immediately." Staff believes that, to the contrary, any informational advantage held by the USFE block trade participants would be extremely limited, as block transactions would not occur until the seller confirmed the block trade on the trading system. At that point, the trade would be instantaneously sent to the USFE, which would "immediately" post the transaction details. (This posting requirement was previously "promptly," but was amended by the USFE to "immediately," subsequent to the CBOT's third comment letter.) Thus, there would be virtually no gap in time between execution and reporting to the Exchange. The 15-minute period referred to by the CBOT is the maximum time period between buyer input and seller confirmation and consequent trade execution. During that time period, neither party would be assured of execution and, thus, would not have any certain informational advantage over the rest of the market.

staff notes that the scenario described by the CBOT is not unique to the USFE's block trade provisions. In fact, the Commission has previously approved block trading rules at other contract markets with cloned contracts that do not prohibit block trade participants from trading in advance of the announcement of a block trade (*e.g.*, the Cantor Financial Futures Exchange (CFFE) and the BTEX).[98] At the BTEX, for instance, one of the rationales offered to support its proposal to institute more expansive block trade reporting requirements was that market makers that are parties to block trades need to hedge their resultant positions before revealing the ultimate size of those positions to the marketplace. Eventually, the Commission approved the BTEX block trade reporting requirements in connection with its designation of the BTEX as a contract market.[99]

In addition, traders frequently take positions on DCMs to hedge their OTC transactions, transactions often known only to them and their counterparties. For example, large grain firms take positions in the CBOT grain futures contracts to hedge their OTC deals with other commercial participants such as farmers and foreign buyers. These traders have a clear informational advantage over the rest of the marketplace.

The third CBOT comment letter correctly observed that the USFE's block trade rule reserved the minimum number of contracts that could be traded in a block transaction. The CBOT noted that if the minimum level was set too low, block trading could overshadow the regular centralized trading market, rather than provide a special, non-competitive execution alternative. Commission staff agrees with the CBOT's comment. Consistent with its prior

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[98] The CBOT seems to implicitly recognize the fact that the USFE's block trading rule is not unique in this regard when the only contrast that it draws between block trading rules at the USFE and other exchanges is that the USFE's rule permits "unfair and unreasonable pricing practices."

[99] *See* June 18, 2001 letter from Jean A. Webb, Secretary of the Commission, to Edmund R. Schroeder (BTEX approval letter).

review of minimum block transaction sizes at other DCMs, at such time that the USFE adopts its thresholds, Commission staff will ensure that they are set at levels that will not compromise "the integrity of prices or price discovery on the relevant market."[100]

In addition to the above CBOT and CME comments on particular aspects of the USFE's block trade provisions, five individuals filed comments on block trading generally. These commenters questioned the fundamental underpinnings of block trading and contended that it, among other things, degraded centralized marketplaces, gave rise to conflicts of interest between principals and agents and benefited only a small number of large firms. Staff notes that the issues raised by these commenters are largely the same issues that the Commission considered when it approved the futures industry's first set of block trading provisions at CFFE in 2000.[101] Since that time, block trading procedures have been implemented at a number of other DCMs and block trading itself is explicitly recognized by the Commission as a potential trading mechanism in its Application Guidance to Core Principle 9.

Commission staff has closely reviewed the USFE's block trading proposal and has found it to be in compliance with the designation criteria and core principles and to be consistent with block trading procedures previously approved by the Commission at other DCMs. The USFE, like all U.S. exchanges with block trading, will be obligated to ensure that its block trading procedures are implemented and continue to operate in an acceptable manner. Commission staff will, of course, perform periodic rule enforcement reviews of the USFE to ensure that all aspects

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[100] Part 38, Application Guidance to Core Principle 9. As previously noted, the USFE has indicated that it plans to set the minimum block trade threshold at 1,500 contracts for the U.S. Treasury bond contract and 2,500 contracts for the U.S. Treasury note contracts it is likely to introduce first.

[101] *See* February 11, 2000 letter from Jean A. Webb, Secretary of the Commission, to Audrey R. Hirschfeld, New York Board of Trade Sr. Vice President and General Counsel, and Memorandum from the Division of Trading and Markets to the Commission recommending approval of the CFFE Block Trading Proposal.

of the Exchange's operations, including its block trading mechanism, remain in compliance with the core principles.

(d) USFE Rules 416 and 417 (EFP and EFS)

The CBOT commented that neither USFE Rule 416 nor Rule 417 place any respective limitations on when EFP or EFS transactions at the USFE may be executed prior to expiration. By comparison, the CBOT points out that its rules permit only liquidating EFP/EFS transactions during the last two days before expiration in order to prevent disorderly contract expirations.

Staff notes that, although the CBOT limits the execution of EFP/EFS trades during the last days of trading before expiration of a contract, that approach is not mandated by any Commission requirement and, in fact, a number of DCMs permit EFP/EFS transactions without such a limitation (*e.g.*, CME Rule 5.38, NYMEX Rule 6.21). Accordingly, staff believes that the determination whether to implement such a provision is a business decision for each contract market.

(5) Membership Application Issues

With respect to the USFE's membership application, the CBOT mentioned that there is no consent or acknowledgement regarding possible investigation on the membership application. However, pursuant to the Membership Agreement, a member consents to the jurisdiction of the USFE and its agents in all matters arising under the agreement and the rules. Moreover, members specifically acknowledge that in any disciplinary proceedings and investigations, they will produce business records reasonably requested of them, permit on-site visits, accept service of process and subpoenas and abide by the Exchange's final decision. In the event of termination of membership, members agree that they will remain subject to the jurisdiction of the Exchange "with respect to any investigation or proceeding" commenced against them by the Exchange. In addition, various USFE rules require members to keep and maintain records and

respond to information requests from the USFE. For example, USFE Rule 307(g) requires members to furnish in a timely fashion such information as may be periodically requested by any officer, employee, agent or committee of the USFE in the course of his or her duties. USFE Rule 309 makes it a rule violation if a member fails to comply with a request for information by the entity contracted by the Exchange to conduct "market, trade practice, financial and sales practice surveillance and related investigations and disciplinary proceedings with respect to Members." The membership agreement and the rules therefore provide adequate notice to members that they may be investigated.

Moreover, the CBOT contends that there is no identification of required documents, nor any explicit reference to any requirement that an entity seeking admission must file any type of financial statement. The chief mechanism for assuring the financial integrity of USFE members is that all trades must be guaranteed through the USFE's DCO, C Corp. In this regard, the USFE requires that, in order to trade, members must themselves be authorized by C Corp to clear trades, or to have their trades guaranteed by an entity that is so authorized. Pursuant to C Corp Rule 204, each clearing member is required to submit a statement of financial condition at such times and in such manner as prescribed by C Corp. In addition, the USFE will determine the financial integrity of prospective members by relying on background and credit checks. Pursuant to the RSA, the NFA will perform financial background checks, which will include a review of Dun and Bradstreet, Experian, Trans Union and/or similar databases to determine if any negative financial information exists. The NFA will also conduct risk analysis interviews to obtain understanding of applicant firms' operations, trading activity, types of customers, etc., and will assess firms' risk management practices. The USFE will also consider whether applicants who are required to be registered are in good standing with their regulators. With respect to FCMs

specifically, FCMs are subject to the Commission's net capital and related reporting requirements. Any new members of the USFE that plan to conduct customer business would be required to register with the NFA as FCMs and would have to maintain the required minimum net capital prior to the effectiveness of registration. In addition, to the extent further information is necessary, USFE Rule 307(g), as noted above, requires members to furnish information as may from time to time be requested by the USFE or any of its agents. Accordingly, Commission staff is satisfied that the USFE will have access to adequate information to verify the financial integrity of its members.[102]

(6) Rules 203, 204 and 207 Relating to Conflicts of Interest

The CBOT made a number of comments with respect to USFE rules concerning conflicts of interest. Staff has considered these comments, but concludes that they are without merit. The CBOT argued that members of the Disciplinary Committee and the Appeals Committee, pursuant to USFE Rules 203 and 204, respectively, will be officers or employees of the USFE, and asks whether such individuals could be expected to reveal potential conflicts of interest to their employer pursuant to USFE Rule 207, and thereby risk losing their jobs as well as their ability to participate on the respective committee. Staff believes that it would be unlikely for a USFE employee to lose his or her job for disclosing a conflict of interest, such as a business or family relationship. On the contrary, it seems far more likely that an employee would be fired for failing to disclose such a conflict.

In addition, the CBOT contended that it is unclear whether the USFE will rely only on self-reporting to detect conflicts of interests, or whether it will affirmatively monitor for possible disqualifications, for example when new directors are nominated. The Act does not

[102] *See also* discussion at 83-87, *supra*.

prescriptively require an exchange to affirmatively monitor for possible conflict of interest disqualifications, but rather to establish and enforce rules to minimize conflicts of interest and to establish a process for resolving conflicts, which the USFE has done. Staff notes, however, that in determining whether a Board or committee member has a conflict of interest in a matter (either because of a relationship with a named party or a financial interest in the matter's outcome), the USFE would be obligated under Rule 207 to look at: (1) information provided by the member, (2) large trader and clearing records (financial interest conflicts only), and (3) any other source of information that is held by and reasonably available to the Exchange.[103] The USFE's rules also 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. Moreover, the rules provide that a respondent who is a named party in interest may serve a written request on the Chief Executive Officer of the USFE for disqualification of any member of any committee of the USFE on the grounds that such member has one of the relationships listed in USFE Rule 207, or that any other cause exists that might lead the member to have a bias against the respondent.[104] Ultimately, as an additional protection, any decision taken by the Exchange would be subject to Commission review.

In addition, the CBOT claimed that the procedure for identifying conflicts of interest in USFE Rule 207(c)(ii) is ineffective because the USFE only will have one director. However, as noted above, the USFE's Board will consist of 12 directors, so this contention is unfounded. The CBOT also argues that Rule 207(d)'s "significant action" provisions would be largely irrelevant

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[103] These bases for conflict of interest determinations were extracted directly from Commission Regulation 1.59.

[104] *See* USFE Rule 617.

since officers and employees are prohibited from trading pursuant to Rule 207(b). Although the USFE officers and employees with access to material non-public information concerning any commodity interest are prohibited from trading in that commodity interest or in any related commodity interest on the USFE pursuant to USFE Rule 207(b), they may trade in other commodity interests in which they do not have access to material, non-public information. In those circumstances, USFE Rule 207(d)'s significant action provisions would be relevant.

Finally, the CBOT argued that officers and employees might be considered to have a "significant, ongoing business relationship" with any possible named party in interest, simply because of the fact of their employment. Presumably, the CBOT means to suggest that employees of the USFE would thereby have a conflict of interest because they would not wish to alienate trading members and reduce exchange revenue. However, member-owners of a contract market who staff disciplinary committees, such as is the case on the CBOT, might also be deemed to have a "significant, ongoing business relationship" with any named party in interest based on this reasoning, since member-owners seek to maximize seat value. It seems more likely that, whether exchange committees are comprised of exchange employees or member-owners, there will be an overarching incentive to minimize conflicts of interest in order to preserve exchanges' reputations for providing fair and efficient markets. The Commission's rule enforcement review process should also serve to ensure that the USFE adequately enforces its conflict of interest rules.

(7) Use of Inside Information by Employees of the USFE's Corporate Affiliates

The CBOT asserted that a foreign board of trade's employees or officials could receive inside information about trading on its U.S. contract market subsidiary from that subsidiary and trade on the basis of that information without violating the Commission's rules or the Act. In

this regard, Section 9(f) of the Act and Commission Regulation 1.59 prohibit employees, governing board members, committee members, and consultants from trading on or disclosing material nonpublic information obtained through special access related to performance of their duties on an exchange. The CBOT stated that this prohibition would not extend to the employees of a foreign board of trade that is "linked" to a domestic exchange. The CBOT further stated that, when the CBOT signed a Market Supervision Services Agreement with Eurex in 2000 in connection with the a/c/e joint venture, the CBOT required all Eurex employees who worked on the CBOT market to sign a letter agreeing to abide by Commission Regulation 1.59 and consenting to the Commission's jurisdiction.

In a subsequent comment letter the CBOT asserted that the USFE's pledge that it will "obtain commitments from employees of affiliates performing regulatory services that they will not trade on inside information" falls far short of closing the statutory loophole and is facially inadequate. The CBOT stated that this statement covers only (1) affiliates, not the parent corporation; (2) those performing regulatory services (leaving it unclear whether this applies to Eurex Frankfurt employees since the USFE claims they will not be performing regulatory services); and (3) trading on inside information, not disclosing it to others.

The USFE has adopted USFE Rule 207 to prohibit the improper use or disclosure of material nonpublic information by any board member, committee member, officer or employee of the USFE, as well as any Board member, officer or employee of any corporate affiliate of the USFE performing functions for the USFE. Thus, under USFE Rule 207, Board members, officers and employees of any corporate affiliate of the USFE that performs any functions for the USFE, including the parent corporation, will be subject to insider trading and disclosure restrictions analogous to those applicable to persons occupying similar positions and performing

similar functions within the U.S. for the USFE. Such persons include directors, officers and employees of Eurex, Deutsche-Boerse AG, SWX and other European affiliates of the USFE.

The USFE has also represented that it will obtain from employees of corporate affiliates performing regulatory services for the USFE (*i.e.*, market supervision as a back-up to the USFE's market supervision) a signed letter agreeing that the employees will: (1) abide by Commission Regulation 1.59 and USFE Rule 207 and not trade on inside information; (2) consent to Commission jurisdiction to enforce that commitment; and (3) agree that the USFE may accept service of communications from the Commission on employees' behalf with respect to that commitment. Furthermore, the USFE represents that all directors, officers, and employees of Eurex, Eurex Frankfurt AG, and other European affiliates of the USFE are prohibited from insider trading as a matter of policy and European Union directive.

Staff believes that Rule 207 and the consents to jurisdiction and service of process that the USFE will obtain from employees of foreign affiliates performing regulatory functions for the USFE adequately addresses insider trading concerns. Board members, officers and employees of USFE foreign affiliates performing functions for the USFE will be subject to insider trading and disclosure restrictions analogous to those applicable to employees of the USFE. Employees of corporate affiliates performing regulatory services for the USFE (*i.e.*, market supervision as a back-up to the USFE's market supervision) will sign a letter agreeing to abide by Commission Regulation 1.59 and consenting to the Commission's jurisdiction. The CBOT adopted a similar approach to establishing safeguards against insider trading when it entered into an agreement with Eurex in 2000.[105] Moreover, Board members, officers and employees of the corporate affiliates of the USFE, wherever located, are independently

[105] Contrary to the CBOT's suggestion, staff sees no reason to pursue rulemaking in this area at this time.

prohibited by Commission Regulation 1.59(d)(2) from knowingly trading on insider information received from an officer, employee, board member or consultant of the USFE.

(8) Allocation of Responsibilities in Disciplinary Cases

The CBOT contended that the USFE's rules and its representations in its application are contradictory with respect to who will litigate disciplinary cases and that the USFE should clarify the dividing line between the authority and responsibilities of the USFE and the NFA with respect to the conduct of trade practice investigations and market surveillance and the use of information gleaned from such investigations and surveillance.

Staff posed questions concerning the respective responsibilities of the USFE's Compliance Department and the NFA, which the USFE specifically addressed in its responses dated November 5, 2003. The USFE stated that initially, its Compliance Department will consist of a Chief of the Compliance Department, who will also act as General Counsel of the USFE. The functions of the Chief of the Compliance Department will be to make those determinations requiring the exercise of discretion that have been reserved to the USFE and not included in the RSA with the NFA. The NFA has been retained to, among other things, conduct trade practice and market surveillance on behalf of the USFE. Specifically, the NFA will perform surveillance for trade practice violations and for market manipulation, price distortions or market congestion, and will have transaction data available on a T+1 basis for this purpose. Market Supervision functions will be conducted by USFE employees. These functions include real-time supervision of the market with respect to cancellation of trades, invocation of the volatility procedures, trading suspensions, and maintenance of proper operation of the Trading System, including oversight of the opening procedures, checking for validity of orders entered into the Trading System, and the appropriate editing of information during the post-trading phase. Market Supervision staff will communicate to the NFA promptly and on an on-going basis any

information that may assist the NFA in the performance of its regulatory activities under the RSA.

Pursuant to Schedule A of the RSA, NFA staff will conduct investigations under the oversight of the Compliance Department Chief, prepare written reports and litigate disciplinary cases in conformity with Part 6 of the USFE's rules. Specifically, if potential irregularities are noted by the NFA in performing its market surveillance functions (or are brought to its attention by the USFE), the NFA's Compliance Department may: (1) review any trades in question in relation to other surrounding trades; (2) gather background information from USFE members and market participants; (3) review activity in relationship to other related markets (cash and other derivative markets); and (4) confer with the USFE's Compliance Chief about the Exchange's customs and practices. Once the NFA's Compliance Department has reason to believe that a matter should be further investigated and possibly referred to the USFE's Disciplinary Committee, the NFA's Compliance Department shall explain the results of its preliminary inquiry to the USFE's Compliance Chief and obtain his or her authorization to conduct an investigation. The matter also would be referred to the NFA's Legal Department. If the USFE Compliance Chief approves the investigation, the NFA's Compliance Department will prepare a written report summarizing its findings. The findings report is presented to the Compliance Chief, who decides whether it shall be forwarded to the USFE's Disciplinary Committee and what, if any, recommendation to make relating to the issuance of a complaint based on the report's content. If the Compliance Chief decides not to authorize an investigation, or decides not to forward a complaint to the Disciplinary Committee (or to forward it without recommendation), he or she must notify the NFA's Compliance Department in writing of this

decision and the reasons therefor. If a complaint is issued, NFA legal staff will prosecute the case on behalf of the USFE.

Staff has concluded that the USFE's November 5, 2003 responses adequately clarify the responsibilities of the USFE's Compliance Department, Market Supervision staff, and the NFA, as provided for under the RSA and the USFE's rules.

(9) Fee Authority

The CBOT commented that USFE Rule 306 would empower the Exchange to impose any fee that it wished. Staff concurs that Rule 306 gives wide latitude to the USFE to impose fees, but that such a provision is not at all unusual for a DCM. Staff believes that, although the imposition of fees might be inappropriate in certain instances, such a determination can only be made on a case-by-case basis after the fee has been established. Unconstrained fee-setting authority by itself does not raise issues under the Act or the Commission's regulations.

(10) Matters Allegedly Not Addressed in the USFE's Rules

(a) Procedures Regarding Orders

The CME commented that USFE rules fail to address several trade practice matters that are vital to market integrity. In particular, the rules do not specifically: (1) require the entry of customer orders in the order of receipt; (2) prohibit the disclosure of orders prior to execution; or (3) prohibit the withholding of orders from the market.

USFE Rule 307(m) requires members to use due diligence in receiving and handling customer orders. USFE Rule 307(n) requires members to establish and enforce internal rules, procedures and controls to give priority to customer orders. In addition, Rule 308 prohibits members from engaging in: (1) conduct that violates Commission regulations, any other applicable law, or the rules of the Exchange or C Corp; or (2) conduct that is inconsistent with just and equitable principles of trade, or detrimental to the best interests of the Exchange. Staff

believes that these provisions, in combination with other customer protections (*e.g.*, NFA trade practice surveillance procedures), provide sufficient safeguards with respect to customer orders so as to comply with Designation Criterion 3 and Core Principle 12.

(b) Fitness Standards

The CME also commented that the USFE's rules do not adequately establish fitness standards for all persons who may have direct access to the Trading Facility, in violation of Core Principle 14.

Exchange fitness standards appropriately apply to Exchange members, who legally are the persons having "direct access to the Trading Facility." USFE Rule 304 disqualifies from membership persons who are unfit, based on a statutory disqualification under the Act. In contrast, "authorized traders" are agents of members, operating under their supervision and control. The USFE membership agreement requires members to advise the Exchange if any of their authorized traders has been convicted of a crime or had their trading privileges suspended or revoked. However, members remain responsible for the actions of their agents who may be authorized to enter trades on the Exchange. In addition, under USFE Rule 307(j), each member is responsible for all obligations in connection with any contract resulting from the entry of any order into the trading system with the member's ID.

Staff believes it is entirely consistent with Core Principle 14 to hold Exchange members responsible, not only for the actions of their agents, but also for evaluating the fitness of those agents for whom they must assume responsibility.

g. Additional Issues

(1) Providing the Public an Adequate Opportunity to Comment

The CBOT, the CME and other commenters asserted that they and other interested parties have not been provided with adequate documentation to critically analyze and constructively comment on the application. In particular, they argue that key documents that were submitted as part of the application have been "suppressed" and that other documents, such as those related to products, have not been submitted to the Commission or made available for public comment. The CBOT contends that public comment is particularly appropriate because the application raises so many new and profound legal questions and regulatory dilemmas. The CME contends that the suppression of key documents violates Section 6 of the Act. It is argued that public comment on all aspects of the application is critical to the Commission's informed assessment.

Staff believes that the documents posted on the CFTC website provided interested members of the public with an adequate and reasonable opportunity to comment. In this regard, the Commission posted portions of the USFE's application on its website as part of its voluntary policy of posting exchange submissions and applications in order to provide the public with information on the industry.[106] There is no requirement in the Act or the Administrative Procedure Act[107] that the Commission post DCM submissions or applications, or seek public comment thereon.[108] In these circumstances, staff believes that the Commission has the discretion to determine which documents it will post on the website.

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[106] *See* August 4, 2003, letter from Jean A. Webb, Secretary of the Commission, to all DCM presidents apprising them of this new policy.

[107] 5 U.S.C. §§ 551 *et seq*.

[108] The Commission's consideration of an application for a contract market designation is an informal licensing proceeding (*see* 5 U.S.C. § 551) and is not, under the Act, its rules, or other applicable law, subject to formal on-the-record procedures.

The CME's suggestion that the Commission violated Section 6 of the Act by failing to make certain exhibits available to the public is without merit. Section 6 establishes the procedure for contract market designation and vests the Commission with the authority to determine whether an application is materially incomplete and whether to approve or deny an application. Section 6 contains no provision for public participation in these decisions and thus the Commission is under no compulsion by that provision to provide the public with the information necessary to make that determination.

Nevertheless, having solicited public comment on the application, staff has not identified any issues that it believes warrant seeking additional comment from the public. Moreover, neither the CBOT nor the CME can explain how their complaints regarding lack of access to confidential materials establish a legal remedy in the form of denial of the application, rather than a remedy through the Freedom of Information Act (FOIA), 5 U.S.C. § 552. The CBOT, the CME, and other interested members of the public have been provided with substantial information concerning the application and an opportunity to comment on all issues as to which staff believes public comment could be helpful to the Commission's consideration of the application.

(2) The USFE's Application and Its True Business Plans

The CBOT contended that the USFE appears to be asking the Commission to approve a way of doing business that the USFE never intends to use. This, according to the CBOT, calls into question the legitimacy and completeness of the application. The CBOT contended that the USFE has two business plans – one "plain vanilla" plan for Commission consideration and one "real" plan to be implemented once designation is granted. The CBOT stated that the Commission should ask the USFE to reveal its true business plan before the Commission approves the application. Both the CBOT and the CME asserted that the clearing link is part of

the USFE's business plan and should be included in the designation application and reviewed by the Commission. One other commenter, a CBOT member, also asserted that the application is incomplete and that it is what is not in the application that should scare the world's fair markets.

Commission staff has evaluated the USFE's formal application and representations to ascertain compliance with the designation criteria and core principles. Staff appropriately considers the materials filed and representations made by an applicant in drawing conclusions as to whether designation is warranted. Moreover, once designation is granted, an applicant is required to abide by its rules and representations. The Commission has the authority to address any violations of the designation criteria and core principles, and the staff conducts periodic rule enforcement reviews to assess a DCM's compliance with the core principles. Subsequent to designation, exchanges may adopt changes to their rules and procedures; however, under the Act, DCMs must, on a continuing basis, comply with all designation criteria and core principles.

Moreover, staff notes that all exchanges continually reassess and adjust their business plans to meet competition and to expand their businesses. In implementing changes to their business plans, DCMs seek Commission approval or certify compliance with designation criteria and core principles as required under the Act. The Commission considers whether to approve new rules or rule amendments or whether to accept certifications when an exchange attempts to implement its revised plans. The Commission has never required a DCM to reveal all of its future plans, which may be in various stages of development and indeed may never be adopted, when considering whether a specific proposal at hand complies with the Act and Commission regulations and policies.[109]

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[109] Moreover, the USFE has made certain undertakings to ensure that the Commission has an adequate opportunity to review and, as appropriate, approve significant futures business plans related to clearing and incentive programs. *See* Section VIII below.

(3) Market Fragmentation

The CBOT commented that market fragmentation could lead to the transmission of conflicting pricing signals or busted trades, resulting in losses to major pension and mutual funds, as well as an erosion of public confidence in futures markets. The CBOT stated that it would expect the Commission would be concerned about designating any new exchange that would result in market fragmentation that could harm national public interests. The CBOT commented that the Commission and the U.S. Treasury could analyze fragmentation issues, including those that might be presented by a recent episode in the trading of an equity security pursuant to unlisted trading privileges on a securities exchange. In another comment, the CBOT stated that its market integrity could be seriously compromised to the extent that the USFE clones the CBOT's Treasury security markets and skims off market share through block trades.

The CBOT's comments seem to raise the issue of the propriety of competing exchanges trading closely related or duplicative contracts, especially if those contracts are based on U.S. Treasury instruments. Staff notes that the Commission has examined this issue on several occasions in the past and has always concluded that the listing of additional contracts is not inconsistent with the Act or the Commission's regulations. For example, in 1978, the Commission stated that different exchanges trading the same contract promotes "competition in the development of viable contract terms and conditions."[110] In 1980, the Commission found that "the opportunity for exchanges to list duplicative and related contracts provides the competition which helps keep the terms and conditions of existing contracts aligned with commercial practices . . . . The contract reproduction process is thus the principal mechanism through which

[110] *See* CFTC's "Responses to the Report by the Comptroller General" (July 14, 1978) chapter 3, question 6.

competition would be expected to increase the efficiency of financial futures markets."[111] Consistent with this philosophy, since 1975, when the Commission was formed, the Commission has approved numerous competing contracts representing virtually all commodity types.

Staff believes that the Commission's previous conclusions regarding the listing of competing duplicative or related contracts remain valid. Moreover, any Commission action to preclude the listing of new contracts would be inconsistent with Section 3(b) of the Act, which provides that one of the key purposes of the Act is to "promote responsible innovation and fair competition among boards of trade." It is not the role of the Commission to decide which particular exchange's contract best satisfies traders' risk management needs -- this rightfully can only be decided by market participants.

Staff also does not believe that the fact that the USFE's Treasury futures contracts would be trading concurrently with the CBOT's contracts raises any problematic issues. The Commission addressed similar issues in regard to situations where electronic markets and open-outcry markets in the same instrument were to trade side-by-side. Moreover, as noted above, the Commission forwarded to the Federal Reserve and the Treasury copies of the USFE designation application along with copies of the draft specifications of the USFE's U.S. Treasury futures and options contracts. In their comment letters, neither the Federal Reserve nor the Treasury expressed any concerns about the USFE's listing of U.S. Treasury futures contracts. In fact, Treasury concluded that the introduction of additional derivative products could boost trading volume, facilitate hedging, enhance liquidity, and reduce costs for Treasury securities and related financial instruments. The Federal Reserve stated that expanded venues for the trading of derivatives could offer more opportunities for assuming and hedging positions in Treasury

[111] *See* "Report to Congress in Response to Section 21 of the Commodity Exchange Act," Pub. L. No. 96-276, 96th Congress, 2nd Sess. Section 7, 94 Stat. 542 (June 1, 1980), pp. 77-87.

instruments, thereby enhancing market liquidity, and that competition between entities, both domestic and foreign, improves efficiency and fosters innovation.

Staff also does not believe that the equity market trading incident referenced in the CBOT's third comment letter raises problematic issues. The referenced incident involved the intermarket trading of a NASDAQ-listed security on a regional exchange. This intermarket trading was governed by an agreement that had been reviewed and approved by the SEC.[112] An arguably premature resumption of trading by the regional exchange after NASDAQ had halted trading in the security highlighted the need for a market-wide consensus of what constitutes a "regulatory" trading halt for purposes of the intermarket trading of securities under the agreement.[113] These concerns have no bearing here since the CBOT and the USFE, while likely to trade similar if not the same products, will operate totally independent markets that trade products that are not fungible. Unlike the Securities Exchange Act, the Act does not establish intermarket trading between competing markets as a regulatory objective.[114] The formation of trading and information links between futures exchanges thus remains a voluntary business decision. Furthermore, contrary to the CBOT's suggestion, staff does not believe that this incident, which occurred about two weeks before the Treasury filed its comment letter, warrants additional consultation with the Treasury.

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[112] The NASDAQ/UTP agreement, among other things, governs the collection, consolidation and dissemination of transaction information for NASDAQ/NM securities traded on an exchange pursuant to unlisted trading privileges. *See* Securities Release No. 28,146 (July 6, 1990).

[113] *See* Securities Week, Vol. 30, No. 50 (December 15, 2003); Securities Week, Vol. 30, No. 51 (December 22, 2003).

[114] *See* 15 U.S.C. 78l(f) (permitting securities listed on any national securities exchange and certain Nasdaq-traded securities to be traded by another national securities exchange).

(4) Abuse or Leveraging of Monopoly Power in Home Markets

Both the CBOT and the CME suggested that foreign ownership of the Exchange raises concerns that: (1) Eurex will use profits realized under a system that protects it from significant competition to subsidize efforts to capture U.S. markets in a manner that creates an uneven playing field for other industry participants; and (2) Eurex may abuse or leverage its apparent monopoly power in its home market to effectuate policies in connection with the USFE that contravene the spirit of U.S. antitrust laws.

Neither commenter has identified any law, regulation, custom or practice, or set of factual circumstances, to support the claim that Eurex is protected from "significant competition" from prospective foreign or domestic competitors in its home market. Nor do the commenters offer support for their claim that Eurex enjoys "apparent monopoly power" in its home market. Monopoly power may be shown by evidence of specific conduct evidencing the entity's power to control prices or exclude competition, or it may be inferred from one entity's large percentage share of the relevant market along with significant barriers to entry. *See Eastman Kodak Co. v. Image Technical Services, Inc.,* 504 U.S. 451, 469 (1992).

Similarly, there is no substantiation for the commenters' claim that Eurex is operating other than in accordance with applicable law. If Eurex is compliant with German law, it may use its lawfully generated profits as its business judgment dictates—which may include investing those profits in the USFE. As long as the competition among U.S. exchanges is fair, having additional risk management alternatives in the financial marketplace enhances competition by providing market users with greater choice in accomplishing their business goals.

This is an application by a U.S.-based entity, the USFE, for designation as a DCM under the provisions of the Act and Commission regulations; if designated, the Exchange will be

subject to Commission oversight and will have a continuing obligation to comply with core principles promulgated pursuant to the Act. Specifically, Section 5(d)(18) of the Act provides that a contract market shall endeavor to avoid: (1) adopting any rules or taking any actions that result in any unreasonable restraints of trade; or (2) imposing any material anticompetitive burden on trading on the contract market. Moreover, the USFE, like all U.S. exchanges, will be subject to Federal antitrust laws. Germany and the U.S. have entered into bilateral information-sharing agreements and pledges of regulatory assistance, and both are party to various multilateral agreements. These agreements assure that Federal regulators should be able to obtain information necessary to pursue any antitrust concerns.

(5) Consideration of Fair Competition Issues

The CBOT commented that it is critical for the Commission to consider whether the Exchange's proposed activities constitute fair competition and are consistent with the public interest to be protected by the antitrust laws. The CBOT specifically has questioned whether it is fair competition for the USFE to pay for order flow to induce market participants to shift to the new exchange, or to charge new market users nothing for an extended period of time. Generally, such arrangements unreasonably restrain trade only where they have no legitimate business purpose and result in a significant degree of market foreclosure.

Consistent with the federal antitrust laws, judicial precedent, its obligations under Section 15(b) of the Act and Core Principle 18, the Commission weighs the anticompetitive effects of a specific arrangement against its potential effectiveness in achieving the policies and purposes of the Act. Accordingly, the Commission evaluates the competitive fairness of any arrangement with particular attention to: (1) exclusivity agreements, if any; (2) the duration of the arrangement; (3) the market power of the participants; (4) the degree of market foreclosure

resulting from the arrangement; and (5) any pro-competitive efficiencies, such as market liquidity and consumer choice, generated by the arrangement. Staff cautions, however, that:

> Even an act of pure malice by one business competitor against another does not, without more, state a claim under the federal antitrust laws; those laws do not purport to create a federal law of unfair competition or "purport to afford remedies for all torts committed by or against persons engaged in interstate commerce."

Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 219 (1993) (citation omitted).[115]

The FTC, which is charged by statute[116] with preventing unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce, has signaled its approval of the pro-competitive efficiencies it believes will result from the USFE's entry into the market. The FTC comment letter notes that "competition from new entrants can encourage producers to become more efficient and responsive to the marketplace. Competitive pressure from non-U.S. firms can have the same positive effect on consumer welfare."[117] Responding to commenters' concerns that a new entrant could attempt to gain market share through predatory pricing behavior that takes the form of incentive and rebate programs, the FTC offered several observations. First, it emphasized that "the Supreme Court has been absolutely clear" that, as a general matter, low prices benefit consumers.[118] Second, the FTC points out that courts routinely decline to find predation: "Because it is difficult to profit from anticompetitive below-cost

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[115] Moreover, it is important to consider whether the complained-of harm is the kind the antitrust laws were meant to protect against. *See, e.g., Cargill, Inc. v. Monfort of Colorado,* 479 U.S. 104, 109 (1986). Reduced profits from lower prices and decreased market share is not the type of harm the antitrust laws were meant to prevent. *Pool Water Products v. Olin Corp.*, 258 F.3d 1024, 1036 (9th Cir. 2001).

[116] Federal Trade Commission Act, 15 U.S.C. § 45.

[117] FTC comment letter at 1-2.

[118] *Id.* at 3, citing *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., Id.* at 224; *Atlantic Richfield Co. v. U.S.A. Petroleum Co.,* 495 U.S. 328 (1990); *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.,* 475 U.S. 574 (1986).

pricing, the Supreme Court has observed that 'there is a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful.'"[119]

In that regard, staff notes that the Court of Appeals for the D.C. Circuit recently declined to find illegal monopolization on evidence that Microsoft provided its "Internet Explorer" browser free of charge to internet access providers that gave it preferred promotional support to their subscribers. *U.S. v. Microsoft Corp.,* 253 F.3d 34, 53-54 (D.C. Cir. 2001) ("[T]he antitrust laws do not condemn even a monopolist for offering its product at an attractive price, and we therefore [do not] condemn Microsoft for offering IE . . . free of charge or even at a negative price."). The U.S. Court of Appeals for the Seventh Circuit found that a new entrant to the tourism market, much smaller than the plaintiff, did not engage in illegal predatory pricing by offering free land tours in Israel to induce clients to use its tour service: "More likely, [the defendant] was discounting to get established in the market, also a lawful step." *Israel Travel Advisory Service, Inc. v. Israel Identity Tours, Inc.,* 61 F.3d 1250 (7th Cir. 1995).

Staff emphasizes that the Exchange will be subject to the federal antitrust laws as well as Commission oversight, and will have a continuing obligation to comply with the core principles of the Act, including the obligation under Core Principle 18 to avoid adopting any rules or taking any actions that materially restrain trade or impose any material anticompetitive burden on trading.

(6) Consideration of Reciprocity Issues

At least one commenter suggested that the Commission should consider issues relating to reciprocity in Germany and other countries, and another commenter suggested that U.S. exchanges would be prohibited from establishing an exchange in Germany.

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[119] *Id.* at 4-5, citing *Matsushita Elec., Id.*. at 589.

There is no factual evidence in the record demonstrating that U.S. exchanges would be prohibited from establishing an exchange in Germany. In fact, as the USFE has noted, German exchange regulators have permitted the licensing of a NASDAQ-controlled NASDAQ Deutschland AG stock exchange to trade securities products in Germany. Moreover, German exchange regulators have allowed the placement in Germany of foreign terminals of futures exchanges including, among others, the CBOT and the CME. Further, as the USFE notes, at some time in the future a U.S. exchange could operate in Germany based on a license received from any other member state within the European Union pursuant to Article 15(4) of the Investment Services Directive. Finally, there is no evidence in the record that the application of any U.S.-owned German exchange has been denied solely because of its foreign ownership.

German law establishes licensing criteria for exchanges using similar standards to those set forth in the Act.[120] The formation of an exchange in Germany requires the approval of the Exchange Supervisory Authority of the German state where the exchange is located. The German Exchange Act requires an operating company that must fund the exchange. This administrating and operating entity has to make available to the exchange the resources required for the conduct and adequate development of the operation of the exchange. It appears that one of the factors that the state supervisory authorities in Germany could, in their discretion, consider is whether an additional exchange was necessary or appropriate. However, this factor seemingly would apply to both a domestic as well as a foreign applicant. Moreover, there is no evidence in the record that this factor has been used by a state supervisory authority to reject an application of a foreign exchange.

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[120] The Commission has granted Regulation 30.10 relief to Eurex upon a finding that Germany's futures regulatory scheme is comparable to that of the U.S. 67 Fed. Reg. 30785 (May 8, 2002). The staff has also granted relief allowing Eurex terminals to be placed in the U.S. *See* CFTC Staff Letter No. 99-48, [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,917 (Aug. 10, 1999).

In general, to be approved in Germany an exchange must establish rules that ensure that the exchange is able to fulfill its duties with due consideration for the interests of the public and trading participants. Exchange rules must include provisions regarding the scope of business of the exchange and of the exchange bodies, the organization of the exchange and the publication of prices and official quotations as well as the respective turnover. The exchanges also are required to develop rules and regulations setting standards of behavior for their members and to promote investor protections. Exchange rules must be approved by the Exchange Supervisory Authorities, which may also modify or supplement exchange rules. The exchanges are responsible for admitting securities and derivatives contracts to listing under the supervision of the Exchange Supervisory Authority, which may take part in admission decisions. There are no specific rules regarding the types of products to be traded.

In order to fulfill its responsibilities, an exchange must establish "exchange bodies," which include the Exchange Council, the Board of Management, the Board of Admissions, the Trading Surveillance Unit, and the Disciplinary Committee. The duties and functions of these bodies are established by the German Exchange Act. The Exchange Council is the governing body of an exchange. It is responsible for the adoption of exchange rules and fee regulations; the adoption of conditions for transactions on the exchange; the adoption of examination regulations concerning professional qualifications to act as exchange traders; the adoption of arbitration rules; the adoption of rules of procedure for the Board of Management; the appointment and dismissal of members of the Board of Management, in consultation with the Exchange Supervisory Authority; the supervision of the Board of Management; the appointment, reappointment and removal of the head of the Trading Surveillance Unit and his or her deputy,

upon nomination by the Board of Management and the agreement of the Exchange Supervisory Authority; and the election of members of the Board of Admissions.

Staff notes that the Act does not make reciprocity a condition of, or a consideration for, contract market designation.[121] Specifically, Section 5(b) provides that to be designated as a contract market, the board of trade must demonstrate to the Commission that it meets the criteria specified in that section. Reciprocity is not one of the designation criteria set out in Section 5(b), nor is it one of the core principles set out in Section 5(d) of the Act. Thus, a demonstration that the home country of the owners of a U.S. exchange provide reciprocity is not required. In other words, the Act does not specifically provide that a lack of reciprocity is a statutory basis for denying an application for contract market designation. Finally, and consistent with the above, reciprocity requirements are not favored in the international agreements to which the U.S. is a party and there is an issue of whether imposing such a requirement could raise questions as to our international obligations.

One commenter noted that the Primary Dealers Act of 1988[122] requires that any foreign applicant for primary dealer status must show that its home country would allow U.S. banks to underwrite that country's government debt on the same terms as applicable to the banks residing in that country. The commenter also noted that the USFE has not shown that U.S. exchanges seeking to expand their operations in the European Community, Switzerland or Germany would be afforded reciprocal treatment. The commenter recommended that the Commission follow

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[121] It is clear that Congress has specifically established reciprocity as a consideration of a Commission action when it deems it appropriate. For example, Section 12(f)(2) of the Act requires that in providing investigative assistance to a foreign futures authority, the Commission consider whether the requesting authority has agreed to provide reciprocal assistance to the Commission in futures and options matters. Even in this provision, reciprocity is not a requirement but a consideration. Congress could have, but did not, explicitly provide similarly that reciprocity should be a consideration in the grant or denial of a contract market designation.

[122] 22 U.S.C. §§ 5341-5342.

"Congress's lead and impose a requirement similar to that which Congress adopted in the Primary Dealers Act of 1988." As noted above, there is no evidence in the record that U.S. exchanges would not be afforded reciprocal treatment. The commenter did not demonstrate or provide any evidence to that effect. Moreover, imposing a reciprocity requirement is in the purview of Congress. Congress, not the Federal Reserve Board, imposed a reciprocity requirement on primary dealer activity. Conversely, as noted above, Congress did not make reciprocity a condition of contract market designation in the Act.

(7) Consideration of Costs and Benefits under Section 15(a) of the Act

One commenter suggested that the Commission is required to consider the costs and benefits of its action before issuing an order designating the USFE as a contract market or denying its application. It was noted that the statute imposes a cost-benefit analysis requirement generically on the Commission before issuing an order "with specific and limited exceptions not applicable here."

Section 15(a)(1) of the Act, which was adopted as part of the CFMA, provides that the Commission shall consider the costs and benefits of its action before promulgating a rule or issuing an order. Section 15(a)(3), however, provides for three separate exceptions from this requirement. Included among those exceptions are Commission actions that are part of an adjudicatory process and Commission actions that "are a finding of fact regarding compliance with a requirement of the Commission."[123]

Staff believes that an order issued in a contract market designation proceeding is not an order for which the Commission is required to consider the costs and benefits of its action under

[123] The third and final exception from the requirement that the Commission consider the costs and benefits of its actions are emergency actions.

Section 15(a)(1). Unlike general regulations and certain orders, the Commission has little discretion when it considers and disposes of an application for contract market designation. Section 6 of the Act governs the designation procedure and provides that an applicant for contract market designation "shall make application to the Commission . . . and accompany the same with a showing that it complies with the conditions set forth in [the] Act, and with a sufficient assurance that it will continue to comply with the requirements of [the] Act." Section 6 further provides that the Commission "shall approve or deny" the application within 180 days of the filing of the application. Thus, if the Commission finds that the applicant meets the requirements of the Act, it is required to grant designation. Section 6 does not permit the Commission to deny an application due to the actual or perceived costs of approving the application.

Furthermore, staff notes that the Commission is not required to approve a contract market designation application by the issuance of an order and that it has not always done so. Moreover, under the Commission's fast track procedures, an applicant whose filing is complete and meets all of the statutory and regulatory requirements for approval could be deemed designated as a contract market 60 days after Commission receipt of the application - without the issuance of any order or other written statement.

Staff believes that it is appropriate to view orders issued in contract market designation proceedings under Section 6 as actions that result from "a finding of fact regarding compliance with a requirement of the Commission" and, thus, not requiring a consideration of costs and benefits under Section 15. In this regard, Section 6 requires an applicant to demonstrate that it *complies* with and will continue to *comply* with the requirements of the Act. If one were to read the exception for actions involving a finding of compliance as limited to more traditional

findings of fact regarding compliance, the exception would be rendered meaningless as any such action would be encompassed by the separate exception for actions that are part of an adjudicatory proceeding.

Nevertheless, staff has considered the costs and benefits of designating the USFE as a contract market in light of the five broad areas of market and public concern identified in Section 15(a): protection of market participants and the public; efficiency, competitiveness, and financial integrity of futures markets; price discovery; sound risk management practices; and other public interest considerations.[124] Staff's considerations address the designation of a new contract market in general and the designation of the USFE in particular.

The designation of a new entity as a contract market has the unambiguous effect of promoting competition and efficiencies in the trading of futures and option contracts. Key features of the CFMA were the elimination of prescriptive regulations and approval requirements to allow exchanges more flexibility in meeting their market and financial integrity obligations and the corresponding removal of barriers to entry to encourage competition among exchanges. Effective competition serves as a driving force in ensuring that exchanges continue to meet industry risk management and price discovery needs, by developing new or improved products, trading systems, etc. As long as each exchange complies with the designation criteria and core principles, the entry of a new exchange enhances competition and fosters efficiencies. In a

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[124] By its terms, Section 15(a) does not require the Commission to quantify the costs and benefits of a new regulation or proposed order or to determine whether the benefits of the proposed regulation or order outweigh its costs. Rather, Section 15(a) simply requires the Commission to ''consider the costs and benefits'' of its action. Section 15(a) further specifies that costs and benefits shall be evaluated in light of five broad areas of market and public concern: protection of market participants and the public; efficiency, competitiveness, and financial integrity of futures markets; price discovery; sound risk management practices; and other public interest considerations. Accordingly, in acting to adopt a new rule or impose a new requirement, the Commission could in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular rule or order was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the Act.

market economy, such competition provides widespread benefits – to the industries utilizing futures and options, which receive superior risk management and pricing tools; to intermediaries and traders in the form of lower fees or superior execution; and to the U.S. and world economies as a result of lower prices and greater transparency.

As noted above, in designating an applicant as a contract market, the Commission must find that the applicant complies with all the requirements set forth in Section 5 of the Act. These requirements were adopted to ensure that market participants and the public are protected. Accordingly, the designation of a new contract market should have no negative effect on the Commission's ability to protect market participants and the public. With respect to financial integrity, each applicant must demonstrate that it has established and will enforce rules and procedures for ensuring the financial integrity of transactions, including the clearance and settlement of transactions with a DCO. Moreover, designation of a new entity should have no adverse effect on the risk management practices of the futures and options industry; in fact, the new entity may offer new or improved vehicles for the industry to manage risk.

Finally, staff has not identified any costs to the public associated with the designation of a new entity as a contract market nor any other public interest considerations that should cause the Commission to withhold designation. As in any competitive situation, a new entrant devotes resources to the development of the new marketplace. If the new entrant fails, these resources would be wasted. If the new entrant succeeds, there may be a reduction of activity at existing exchanges. This does not result in a net cost to society, but rather it represents the inevitable rearrangement of capital, labor and profits inherent in a competitive market. Congress recognized the benefits ensuing from competition since, as noted above, the Act provides that if

the Commission finds that an applicant meets the requirements of the Act, the Commission is required to grant designation.

With respect to the USFE application, as discussed extensively above, staff believes that the USFE has demonstrated that it meets the designation criteria, the core principles and the Commission's regulations. Staff has not identified any costs unique to the designation of the USFE as a contract market, nor any other public interest considerations that have not been fully addressed above. After considering each of the factors set forth in Section 15(a) with respect to costs and benefits, staff recommends that the Commission designate the USFE as a contract market.

VI. The USFE and C Corp Undertakings

In connection with this application, the Commission has received voluntary undertakings from both the USFE and C Corp.

The USFE has made four specific undertakings in a letter dated January 26, 2004. These commitments relate primarily to implementation of a cross-border clearing link which would permit USFE listed or traded futures contracts to be cleared outside the U.S. by a clearing house that is not registered with the CFTC as a DCO. Essentially, these commitments ensure that any type of cross-border clearing link would require prior Commission review and approval before implementation. First, the USFE agreed that it would not submit prior to the third quarter of 2004 an application to implement such a clearing link with a non-DCO. Second, the USFE agreed not to implement such a clearing link without prior Commission approval or permission. Third, the USFE agreed to provide the Commission with any non-traditional incentive program one month in advance of when the USFE intends to implement such a program. Fourth, the USFE agreed that, without prior Commission approval, it will not operate BTEX as a contract market in reliance on the designation previously granted to BTEX by the Commission.

Similarly, C Corp voluntarily submitted to the Commission three specific undertakings in a letter dated January 23, 2004. These undertakings also relate to the implementation of a proposed cross-border clearing a link. First, C Corp agreed that prior to the third quarter of 2004, C Corp would not file with the Commission an application which would approve, certify or permit C Corp's utilization, directly or indirectly, of any clearing organization that was not a Commission-registered DCO, in connection with the clearing, settlement, netting, offsetting of, or other implementation of any clearing link for USFE listed or traded contracts. C Corp also agreed that it would not engage in any of the afore-mentioned activities without the prior approval or permission of the Commission or its staff. It was understood that this undertaking would not prohibit C Corp from filing with the Commission or its staff an application or request for regulatory action to clear, net, settle, offset (either position or risk), or implement a clearing link for futures and options contracts, whether dollar denominated or non-dollar denominated, that are listed or traded other than on a DCM.

Second, C Corp agreed that it would not provide clearing services for futures and options contracts that are listed and traded on any affiliate of the USFE and that it would not implement portfolio margining between, or any form of clearing link involving, futures and options contracts that are listed or traded on the USFE and those that are listed or traded on any affiliate of the USFE, without consultation with and the prior consent or approval of the Commission. For this purpose, C Corp agreed that the Commission would have 10 business days from the date C Corp makes a formal submission to determine whether C Corp may self-certify such an arrangement pursuant to Commission Regulation 40.6, and that if the Commission does not object by the close of business on the 10th business day, the arrangement would be deemed proper for certification.

Third, C Corp undertook that the first and second undertakings would not prohibit C Corp from seeking, prior to the third quarter 2004, approval or permission from the Commission or its staff to enter into a cross-margining arrangement involving USFE listed or traded contracts, whether dollar denominated or non-dollar denominated, with a clearing organization that was not a Commission-registered DCO or a clearing agency registered with the SEC. It was further understood that C Corp would not need to seek prior Commission approval or permission to enter into a cross-margining arrangement, for non-customer positions, with respect to USFE listed or traded contracts, whether dollar denominated or non-dollar denominated, with a Commission-registered DCO or a clearing agency registered with the SEC.

The Commission has clear legal authority to impose conditions in its order approving the USFE's application for contract market designation.[125] In this regard, the Commission may also accept voluntary undertakings from applicants and make them binding conditions in an order of designation. The Commission also has legal authority to consider undertakings that are offered in its consideration of a contract market designation application, and it may refuse to accept any undertakings so offered. For example, as recommended by Commission staff, the Commission may refuse to accept the undertakings offered by the USFE and C Corp that they will not submit for approval any cross-border clearing link application prior to the third quarter of 2004. For the undertakings to be legally enforceable and binding on the USFE or C Corp, they must be included in the Commission order approving the USFE's contract market designation application. These specific conditions and undertakings, which are set forth in the Commission's

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[125] The Commission's regulations provide for designation of contract markets upon conditions as determined by Commission order. *See* Commission Regulation 38.3(a)(1), 17 C.F.R. § 38.3(a)(1). Moreover, the Commission has a longstanding practice to condition contract market designation approvals. *See, e.g.,* Order of Conditional Designation In the Matter of the Application of Nasdaq LIFFE, LLC Futures Exchange for Designation as a Contract Market (Aug. 21, 2001); Order of Initial Designation In the Matter of the Application of FutureCom, LTD, for Designation as a Contract Market in Cash-Settled Live Cattle Futures Contracts (Mar. 13, 2000).

Order of Designation, will thus be enforceable under Section 6(b) of the Act, 7 U.S.C. § 8(b),[126] which provides for revocation of designation in the case of a DCM which violates an order of the Commission.[127]

VII. List of Key Supporting Documents[128]

A. USFE Submissions

1. September 16, 2003, USFE Contract Market Application Overview
2. Regulatory Chart
3. Certificate of Formation
4. Amended and Restated Bylaws
5. Amended and Restated Limited Liability Company Agreement*
6. Exchange Rules
7. Membership Applications and Agreement
8. Revenue Commission Agreement*
9. NFA Regulatory Service Agreement*
10. Market Supervision Trading Business Procedures*
11. General Services Agreement with Eurex Frankfurt AG*
12. Service Level Agreement with Deutsche Boerse AG*
13. Clearing Services Agreement with C Corp*
14. Disaster Recovery Plan*
15. User Guide
16. Response to CFTC Technical Questionnaire
17. Information Manual and System Overview
18. Operations Manual*

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[126] Section 6(b) of the Act authorizes the Commission to suspend or revoke the designation or registration of any contract market upon a showing, in particular, that the entity "is violating or has violated any of the provisions of this Act or any of the rules, regulations, or orders of the Commission thereunder." 7 U.S.C. § 8 (b).

[127] Moreover, Section 5e of the Act, 7 U.S.C. § 7b, authorizes the Commission to suspend for up to 180 days or revoke the designation of any registered entity, as defined in Section 1a(29) of the Act, for violating among other things any order of the Commission. Registered entities, of course, include DCOs, *see* Section 1a(29)(C) of the Act, 7 U.S.C. § 1a(29)(C).

[128] These and other supporting documents are before the Commission for its review. Documents on this list marked with an asterisk (*) are subject to a petition for confidential treatment under the FOIA.

19. Front End Installation Guide
20. Front End Operations Guide
21. Internal Trading Manual*
22. Security Manual*
23. Security Coordinator Manual
24. Responses to CFTC Staff Questions (submitted November 4, 2003)
25. USFE Letter to the Commission dated November 18, 2003
26. Responses to CFTC Staff Questions (submitted December 5, 2003)
27. Responses to CFTC Staff Questions (submitted January 20, 2004)
28. Responses to CFTC Staff Questions (submitted January 23, 2004)*
29. Letter to Patrick J. McCarty, General Counsel, and Michael Gorham, Director, Division of Market Oversight dated January 23, 2004*
30. Letter to Patrick J. McCarty, General Counsel, and Michael Gorham, Director, Division of Market Oversight dated January 26, 2004

B. The Clearing Corporation Submission

1. Letter to Patrick J. McCarty, General Counsel, and James L. Carley Director, Division of Clearing and Intermediary Oversight dated January 23, 2004

C. NFA Submissions

1. Letter to the Commission dated November 4, 2003
2. PowerPoint presentation to CFTC Staff (December 2, 2003)*
3. NFA's Trade Practice and Market Surveillance Program (submitted December 2, 2003)*
4. Description of the NFA's Trade Practice and Market Surveillance Activities (submitted November 26, 2003)
5. Interface Specification, NFA Market Surveillance (submitted December 2, 2003)*
6. Interface Specification, TCC to the NFA (submitted December 2, 2003)*

D. Comment Letters and Related Submissions

1. CBOT Letter to the Commission dated October 16, 2003
2. CBOT Letter to the Commission dated December 9, 2003
3. CBOT Letter to the Commission dated December 19, 2003
4. CME Letter to the Commission dated October 16, 2003

5. CME Letter to the Commission dated December 19, 2003
6. Department of the Treasury Letter dated December 18, 2003
7. Board of Governors of the Federal Reserve System Letter dated December 18, 2003
8. FIA Letter to the Commission dated October 15, 2003
9. Interactive Brokers Group, LLC, Letter to the Commission dated October 21, 2003
10. DRW Holdings, LLC, Email to the Commission dated November 7, 2003
11. Brian Hynes, Email to the Commission dated September 29, 2003
12. Klaus Gagel, Email to the Commission dated October 2, 2003
13. Sascha Bauer, Email to the Commission dated October 16, 2003
14. Jack Rhoades, Email to the Commission dated November 18, 2003
15. Patrick Young, Email to the Commission dated October 31, 2003
16. Daniel G. Weaver, letter to the Commission dated December 15,
17. Celtic Brokerage, Inc., Email to the Commission dated December 17, 2003
18. Jerrold M. Duzenman, Email to the Commission dated December 16, 2003
19. Thomas G. Bernicky, Letter to the Commission filed December 18, 2003
20. Paul L. Richards, Email to the Commission dated December 17, 2003
21. Paul L. Richards, Email to the Commission dated January 28, 2004
22. Carl M. Zapffe, Email to the Commission dated December 17, 2003
23. Mark T. Rowley, Letter to the Commission filed December 17, 2003
24. James L. Weiner, Letter to the Commission filed December 18, 2003
25. David Fox, Letter to the Commission filed December 19, 2003
26. Nickolas J. Neubauer, Letter to the Commission dated December 16, 2003
27. Gary R. Knight, Email to the Commission dated December 19, 2003
28. Managed Funds Association, Email to the Commission dated December 19, 2003
29. Robert A. Schwartz and Avner Wolf, Letter to the Commission dated December 19, 2003
30. John J. Lothian, Email to the Commission dated December 19, 2003
31. Atlantic Metals, Limited, Email to the Commission dated December 15, 2003
32. Atlantic Metals Limited, Email to the Commission dated December 19, 2003

33. Lee B. Stern, Letter to the Commission dated December 18, 2003

34. Justin Dugan, Letter to the Commission dated December 19, 2003

35. Nicholas C. Zagotta, Letter to the Commission dated December 19, 2003

36. Federal Trade Commission, Letter to the Commission dated January 12, 2004

37. Timothy J. Muris, Chairman, Federal Trade Commission, Letter to the Commission dated January 20, 2004

38. Joint Letter from The American Bankers Association, The Bond Market Association, Financial Services Roundtable, Futures Industry Association, International Swaps and Derivatives Association, Managed Funds Association, and Securities Industry Association to the Commission dated January 26, 2004

39. Michael D. Morelli, Email to the Commission dated January 28, 2004

40. Edward C. Spencer, Email to the Commission dated January 30, 2004.

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