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COMMENT

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VIA FACSIMILE AND FEDERAL EXPRESS
Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Proposed CFTC Regulatory Reform Rulemaking

Dear Ms. Webb:

The New York Mercantile Exchange (NYMEX or the Exchange) appreciates the opportunity to comment, on its own behalf and on behalf of its wholly-owned subsidiary, Commodity Exchange, Inc. (COMEX), on the Commodity Futures Trading Commission's (CFTC or the Commission) regulatory reform proposals that were recently published for public comment. These proposals will be referenced collectively in this comment letter as the "Reform Proposal." NYMEX wishes to express at the outset its appreciation to the Commission Chairman, to the other CFTC Commissioners and to Commission staff for the openness and accessibility they have offered throughout this regulatory process.

NYMEX is a not-for-profit corporation organized under the laws of the State of New York.[1] It has been designated by the Commission as a contract market for the trading of numerous commodity futures and commodity futures option contracts. NYMEX is the largest exchange in the world for the trading of futures and option contracts based on physical commodities. In 1999, nearly 110 million contracts were traded at the Exchange. Public investors in our markets include institutional and commercial producers, processors, marketers and users of energy and metals products.

I. Introduction and Support for Overall Design and for Use of Core Principles

In general, NYMEX strongly supports the overall design of the Commission's Reform Proposal. Under exemptive authority that was first granted to the CFTC in 1992, the CFTC is proposing to use this exemptive authority to create a broad exemption from many of the rules that now apply to futures exchanges and other regulated entities. Specifically, the Commission Is proposing three new regulatory market categories; each of these regulatory tiers would apply to a "multilateral transaction execution facility," a term that has been used in the CFTC's Part 35 swaps exemption and now would be defined as part of the Reform Proposal. In other words,

1 On July 26, 2000, the Commission approved Exchange rules and procedures that would implement a NYMEX demutualization proposal. Before this demutualization plan can be implemented, the Internal Revenue Service (IRS) must take certain action requested by the Exchange. As of the date of this comment letter, the IRS has not yet taken the requested action.

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The New York Mercantile Exchange is composed of two divisions. The NYMEX Division offers trading in crude oil, heating oil, unleaded gasoline, natural gas, electricity, propane, platinum, and palladium. The COMEX Division offers trading in gold, silver, copper, and the Eurotop 100® index.

the CFTC is proposing to replace the current "one-size-fits-all" regulation for futures markets and to establish three regulatory tiers for markets: recognized futures exchanges (RFEs), derivatives transaction facilities (DTFs) and exempt multilateral transaction execution facilities (exempt MTEFs).

The CFTC also is proposing to replace many of its existing, detailed, prescriptive rules with broad, flexible performance-based "Core Principles." These Core Principles are intended to be tailored to match the degree and manner of regulation to the varying nature of the products traded on the applicable market and to the sophistication of customers using that market. With the exception of certain financial provisions, such as default provisions where specific provisions would better enable market participants to understand their rights and responsibilities, the Exchange also strongly supports the proposed use of Core Principles.

In view of the rapid pace of technology, NYMEX believes that use by the Commission of broad performance standards that are articulated in the form of Core Principles is more appropriate than the use of detailed, prescriptive rules, which could quickly become outdated. In this regard, many experts believe that technological innovation and development will continue at a strong pace for some time to come. Thus, for example, many technology experts believe that Moore's Law may continue to hold for 15 years or more.[2]

To a significant extent, use of Core Principles and allowing markets to self-certify that rules and contracts comply with these principles would result in the CFTC operating in more of an oversight capacity in its regulation of such markets. NYMEX strongly supports this change. At the same time, the Exchange recognizes that, concomitant with this change, the CFTC will need to maintain strong and swift enforcement capabilities, and the Exchange will continue to support the Commission's enforcement efforts.

In light of the comments that have been previously provided on an informal basis by Exchange staff, this comment letter generally will emphasize the few remaining areas of the Reform Proposal that the Exchange respectfully suggests warrant reconsideration by the Commission.[3] The Exchange believes that, at this stage of the regulatory process, discussion of these topics would provide the greatest benefit and assistance to the Commission as it prepares final rules.

However, this focus should not obscure the Exchange's judgment that the Commission deserves great credit for undertaking, on a tight timetable, an urgently needed yet difficult and daunting regulatory reform project. NYMEX commends the Commission for striking a regulatory balance in the Reform Proposal that would modernize and streamline the Commission's regulations and that also would continue to provide appropriate regulatory protections and continue to serve the public interest.

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2 In the mid-1960s, Intel cofounder Gordon Moore first observed an empirical trend that has come to be referred to as Moore's Law, which had stated that the number of transistors that can be fitted onto a single silicon chip doubles approximately every 18 months. More recently, Moore changed the law to every 24 months.

3 The Exchange will also provide comment on certain issues where such comment was requested by the Commission and where comment is relevant to the Exchange's roles as an execution facility or as a clearing organization.

II. A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations and Exemption for Bilateral Transactions

A. Exempt Multilateral Transaction Execution Facilities

In the CFTC's proposed new Part 36, the Commission is proposing a new regulatory tier applicable to certain markets that would make such markets exempt from all Commission regulations, with the exception of anti-fraud and anti-manipulation provisions. This regulatory exemption, which is self-executing, is limited to markets in seven specified product categories, which may be broadly summarized as liquid financial instruments or intangible commodities, e.g., weather index contracts.

The suggestion has been made in certain quarters that this broad exemption from most CFTC regulation should be extended to additional commodities, including energy contracts. NYMEX disagrees. The President's Working Group drew a distinction in its report that limited exclusion from CFTC regulatory authority to financial derivatives. The Working Group's reasoning, in part, was that financial derivatives had "virtually inexhaustible supplies" and that dealers in the swaps markets, such as financial institutions, FCM affiliates, or SEC-regulated broker-dealers, were subject to other forms of regulatory oversight. That is not the case with many participants in the OTC energy derivative marketplace.

The Exchange has consistently voiced the need for modernizing the regulatory structure that has restricted the creativity of futures exchanges to meet the needs of the marketplace. However, NYMEX has also been consistent in acknowledging the need for appropriate levels of oversight when energy commodity trading systems provide a venue for multilateral transactions that give rise to price formation functions, and to which a clearing function adds credit enhancement, and thus mutualizes and concentrates financial risk. Because the President's Working Group focused primarily upon financial derivatives in its report, one may reasonably conclude at this time that the case has yet to be made that such wholesale exemption from CFTC regulation for energy derivatives would serve the public interest.

B. Derivative Transaction Facility

Under proposed new Part 37, there are essentially three ways that a MTEF could qualify for regulation under the DTF regulatory tier:

(1) list for trading only those exempt commodities noted above that could be traded on an exempt MTEF;
(2) apply to the CFTC on a case-by-case basis by contract; for a non-agricultural commodity or
(3) list for trading any non-agricultural commodity, but limit trading only to those entities that qualify as an "eligible commercial participant" as defined in Part 37.

The first commodity-specific approach refers principally to financial contracts, while the latter two approaches appear to be designed for markets offering trading in physical commodity derivatives. Accordingly, in view of the Exchange's current product lines, this comment letter shall focus upon the second and third means of obtaining DTF status for a particular contract. As both of these approaches principally are applicable to physical commodity derivatives, NYMEX would like to begin its analysis of these approaches with a few general comments about physical commodity markets.

1. Liquidity Needs of Physical Commodity Derivatives Markets

Unlike the markets for financial derivative products, which potentially may have thousands of market participants, the pool of market participants for physical commodity derivatives is significantly smaller. One may speculate that the smaller group of potential market participants would mean that physical derivatives markets have a greater need for sources of liquidity other than from market participants hedging their own price risks.

Indeed, that has been the Exchange's experience in its energy contracts. Each month, the Exchange prepares a monthly analysis of the market share of trading volume that is categorized by the CFTC's customer type indicator codes (CTI). Copies of the overall summary from several recent monthly reports have been included as attachments to this comment letter. The breakdown by CTI code includes a column that combines the percentage of trading volume provided by professional floor traders engaging in proprietary trading for their own accounts (CTI Type 1) with the percentage of trading volume provided by the execution of an order given on the floor by one floor member to another floor member for the proprietary account of the first floor member (CTI Type 3).

These trading volume percentages, which have been fairly consistent over the years, indicate that professional floor traders, who are referenced as "locals" in industry parlance, generally provide approximately 43-49% of trading volume in our active energy futures contracts. By comparison, it is the Exchange's understanding that locals generally provide approximately 20-25% of trading volume in a number of financial futures markets. Thus, while the difference in liquidity provided by locals in physical futures markets as compared to financial futures markets is more a difference of degree than a difference in kind, it is nonetheless worth noting that locals provide nearly one-half of the trading volume for many Exchange energy futures contracts.

The importance of locals to energy futures markets is further highlighted by consideration of the Exchange's open interest information. Although the Exchange's open interest data are not categorized by CTI code, NYMEX can nonetheless state unequivocally that the percentage of open interest maintained by locals in the Exchange's energy contracts is extremely small. In other words, it is relatively uncommon for locals to maintain open positions overnight. Instead, locals will typically seek to be "flat" in the market by the end of the trading session. Thus, by comparing such open interest information with the trading volume data, it becomes evident that locals play a critical role at NYMEX in providing intraday liquidity at the Exchange.

To give an example, at any one point in time, the quantity of buy orders for a particular energy contract may not balance perfectly with the quantity of sell orders for that contract. Thus, a local may establish a long position in the market by buying from a seller and will later offset that position by selling the contracts to a willing buyer. In other words, locals serve the market by in effect over time becoming the buyer to willing sellers and the seller to willing buyers.

In addition, it is a fairly common phenomenon in both the OTC and exchange-traded markets for the market participants in the particular energy industry involved to want to trade in the same direction. In other words, industry participants will react to the same economic or other industry development and so generally may seek to buy or to sell at the same time. Hence, there is a great need for other market participants to step in and fulfill a market making role and provide liquidity on one side of the market when no one else is willing to do so. By

reducing the potential for a market to become one-sided, market makers may be viewed as lessening to some extent the regulatory concerns otherwise associated with possible manipulation.

In taking on such positions, locals allow other market participants to establish and terminate positions in the market with a measure of immediacy. The value of this service should not be underestimated. A market participant, for example, may seek to close out an established position in a particular energy contract because that participant is unwilling to be exposed to the market or price risks associated with maintaining that position. A local, depending upon the local's prior position in the market, would be assuming some degree of market risk in establishing a long or short position for the local's proprietary account in a trade involving an order from that market participant. Assuming such market risk requires a sophisticated understanding of the operation of markets as futures prices can change rapidly in response to changes in the fundamentals for the underlying physical.

Thus, it is clear that physical commodity derivatives markets have a pronounced need for persons or entities to provide a market making function in order to ensure that there will be sufficient liquidity for such markets. While the regulatory scheme applicable to OTC energy derivatives markets differs from the regulatory scheme now in place for exchange-traded energy derivatives, the two markets are comparable in many respects. For example, standardized swaps are becoming increasingly common, and information concerning OTC prices are more widely available through a variety of sources. While commodity swaps constitute approximately 1% of overall swap transactions, it is nonetheless worth noting that it has been our experience that 80-90% of energy swap transactions involve standardized swap agreements. Moreover, for the commodities traded on NYMEX's markets, these standardized terms generally mean that these instruments are either NYMEX look-alike contracts or incorporate certain NYMEX terms and/or prices.

Therefore, there are in practice two markets that both offer standardized products and market makers who provide liquidity in each of these markets. In the OTC market, it generally would be a "dealer" maintaining a swap book who would fulfill this role, and in the ring or to some extent on an electronic trading facility, the market making service is provided by locals. In other words, locals today fulfill the same economic role and thus serve as the functional equivalent to dealers acting as market makers in OTC markets.

2. Liquidity for Physical Derivatives Markets under the CFTC's Proposed Case-by-Case Approach to Obtaining DTF Status

Proposed new CFTC Rule 37.2(a)(2)(ii) would provide that "[p]articipants that are not eligible participants as defined in § 35.1(b) of this chapter may have trading access only through a registered futures commission merchant that operates in accordance with the provisions of § 1.17(a)(1)(ii) of this chapter." (emphasis added.) Under related amendments to Rule 1.17, such participants would be limited to participating in the market through a large FCM with at least $20 million in adjusted net capital. In other words, direct trading access to the market under this approach to becoming a DTF would be limited to those persons and entities that are now eligible to qualify as "eligible swap participants" for purposes of the CFTC's Part 35 swaps exemption.

Although a number of changes have been proposed to Part 35 by the Commission as part of this comprehensive reform package, the requirements applicable to local market makers who are registered with the CFTC as professional floor traders would remain unchanged.

NYMEX believes strongly that these requirements are unduly restrictive, could restrict needed liquidity and thus would disadvantage all market participants. Therefore, the Exchange suggests that the standard for eligible participant that incorporates the Part 35 eligibility standards should be revisited by the Commission.

Under current Part 35 requirements, a floor trader that is a natural person or a proprietorship must meet the requirements of subsection (vi) of (xi) of Rule 35(b). In other words, a floor trader who is a natural person must have total assets of at least $10 million. As an alternative, a floor trader that is a proprietorship (with the exception of a proprietorship formed solely for the specific purpose of qualifying as an eligible swap participant) also could qualify under two other tests. First, the proprietorship could qualify if the proprietorship had a net worth of $1 million and entered into a particular swap agreement to hedge a risk in its line of business. Second, the proprietorship could qualify financially if it obtained a letter of credit or similar guarantee, but only from a subset of the financial institutions (or from a governmental entity) listed as eligible swap participants under Part 35. In other words, a floor trader that is a proprietorship may not obtain a guarantee from a FCM under Part 35, but instead must obtain such a guarantee from a bank or comparable financial institution.

The usefulness of this alternative, i.e., organization as a proprietorship for a floor trader, is fairly limited. In general, floor trader registrations generally are made in the name of the individual trader. Even if a floor trader was inclined to organize as a proprietorship, a futures exchange membership or seat historically has been held in the name of one individual, and exchanges by and large will only allow member rates for trades transacted for accounts held in the name of that individual; member rates typically would not be allowed for a corporation owned by that person, even if that person owned 100% of the corporation.[4]

The Exchange does not oppose some financial standard for locals to ensure their financial wherewithal, but also believes that it is unwise public policy to provide that only locals who are organized as proprietorships may obtain a letter of credit or similar guarantee and to provide further that such a guarantee may not be issued by a FCM. Among other things, organization as a proprietorship may raise other issues such as the extent of an individual's liability in an enforcement or litigation context.

The financial restrictions imposed on locals were unduly narrow when Part 35 was first proposed in 1992. At this point, nearly eight years on, the Exchange believes that, in connection with the other changes that the Commission is making to Part 35, now would be an opportune time to revisit this area.

In commenting upon Part 35 when it was originally proposed, a number of exchanges suggested that a floor trader should be permitted to obtain a guarantee of financial performance from a clearing member as a substitute for the proposed financial requirements. In the Federal Register release promulgating the final rules, the Commission did not analyze this suggestion. Instead, the Commission simply indicated in a footnote that it declined to adopt this proposal. [5] Elsewhere in the release, the Commission indicated that it was using the total asset requirement

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[4] This industry practice may be subject to change in a demutualized environment.

[5] 58 FR 5587 (January 22, 1993), reprinted in [1992-1994 Transfer Binder] Com. Fut. L. Rptr. 39,586 at 39591.

as an indication of financial sophistication. [6] In other words, the Commission's original approach to Part 35, by imposing financial requirements as the sole approach to assuring the financial performance of professional floor traders who were not organized as proprietorships, made no recognition of the market sophistication of local market makers and instead essentially treated locals organized as natural persons in the same manner as dentists.

The Commission declined to offer a principled justification for this regulatory treatment in issuing the final rules for Part 35. In the absence of such a rationale, NYMEX believes that it is appropriate for the Commission to reconsider these requirements. Moreover, the many changes in OTC markets since that time also warrant revisiting this issue. In addition to the increasing standardization of OTC products noted previously, the OTC and exchange-traded markets are becoming increasingly linked in a number of ways. For example, in May, the Exchange launched a new futures contract, the Middle East Sour Crude Oil futures contract, which provides for exchanges of futures for swaps for this contract. This linking is useful to both markets. In future years, it is reasonable to anticipate that energy swap products and comparable products that are currently available only in OTC markets will be traded on MTEFs and may be cleared on the same clearing platforms as exchange-traded products. Therefore, in view of the net margining and other potential benefits of such initiatives, there will be a tremendous advantage for a market participant, including professional market makers, to have the opportunity to trade both types of products.

NYMEX suggests that the simplest and best way to revise the definition for eligible participants for trading on a DTF, which as proposed would incorporate the Part 35 requirements, would be for the Commission to modify Part 35. After all, professional local market makers have passed the requisite fitness and background checks and are registered with and regulated by the CFTC. All trades for such professional market makers are cleared through FCMs, and such market makers have developed the necessary sophistication to provide market making services in volatile markets.

Moreover, Section 4(c)(3) of the Commodity Exchange Act (CEA) specifies the persons or classes of entities that are recognized as "appropriate persons" for purposes of that subsection. Floor traders are included in this list, as are FCMs. Thus, Congress has already made the determination that professional floor traders are eligible for participating in such markets.

It is true that, in a later subsection of Section 4(c), the CEA provides that the Commission may impose terms and conditions upon its use of this exemptive authority, including with respect to the issuance of a swaps exemption. However, the Commission must determine that such terms and conditions are appropriate pursuant to paragraph (1) of Section 4(c), which refers to promoting "responsible economic or financial innovation and fair competition."

NYMEX believes that the policies of responsible economic or financial innovation and fair competition support the Commission revising Part 35 to permit all floor traders, including floor traders who are natural persons, as a substitute for the total asset requirements, to be allowed to obtain a guarantee from a FCM. In other words, the Exchange contends that it is entirely appropriate for the Commission to use its statutory authority under Section 4(c) of the CEA to include conditions in Part 35 by requiring floor traders, who are one category of appropriate persons under Section 4(c), to obtain a guarantee from a FCM, which is another category of

[6] Id.

appropriate persons under Section 4(c).[7] The Exchange believes that, for purposes of providing guarantees to locals under the Part 35 swaps exemption that would thereby also become the guarantee standard for locals (as eligible participants) for purposes of trading conducted on a Part 37 DTF, the Commission should allow any registered futures commission merchant that is a clearing member at a market regulated by the CFTC to provide such a guarantee.

3. Trading "Through" a FCM for Purposes of the CFTC's Proposed Case-by-Case Approach to Obtaining DTF Status

It is NYMEX's understanding from conversations with CFTC staff that trading through a FCM would mean that an order would need to be transmitted to the FCM to be then forwarded through its order-routing system to the trade execution facility. It would appear that this provision is intended to give FCMs a measure of control over their exposure from the customer orders.

However, this provision would appear to be premised upon the notion that the credit checking and position limit functionality would reside only within the FCM's internal systems. Some FCMs may well have their own internal systems. However, this approach would seem to overlook the fact that certain trading systems, such as NYMEX's NYMEX ACCESS® electronic trading system, maintain the credit checking functionality as a component of the host computer; Clearing Members may enter inputs into the system to set specific limits per customer. Therefore, the Exchange suggests that the Commission consider addressing both system designs by adding the following language to this provision:

> Participants "that are not eligible participants as defined in § 35.1(b) of this chapter may have trading access only through a registered futures commission merchant unless the credit filter used by the futures commission merchant is maintained as part of the derivative transaction facility. . . ."

4. Liquidity for Physical Derivatives Markets under the CFTC's Proposed Commercials Market Approach to Obtaining DTF Status

Proposed new Rule 37.2(a)(1) would provide that "[o]nly eligible commercial participants trading for their own account have trading access to the derivatives transaction facility for contracts, agreements or transactions in any commodity except for those listed in section 1(a)(3) of the Act." Under proposed Rule 37.1(b), "eligible commercial participant" is defined as and would be limited to:

"a party or entity listed in Secs. 35.1(b)(1), (b)(2), (b)(3), (b)(6) and (b)(8) of this chapter

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7 Moreover, making this change would allow the Commission to rectify an anomaly that now exists in Part 35. Specifically, under Rule 35.1, a commodity pool that meets the specified total assets requirement may issue a letter of credit or other guarantee to a floor trader organized as a proprietorship, even though such guarantees typically would not be provided as part of the commodity pool's usual business activities. However, Rule 35.1 does not allow a FCM to provide a guarantee to such a floor trader, even though many FCMs routinely provide guarantees to floor traders and such guarantees are a standard business practice for these FCMs. NYMEX suggests that Part 35 should be corrected to permit FCMs, who have the expertise in assessing their exposure to trading activity undertaken by local floor traders, to be included in the entities in Part 35 that may provide a guarantee to a registered floor trader.

that in connection with its business, makes and takes delivery of the underlying physical commodity and regularly incurs risks related to such commodity, or is a dealer that regularly provides hedging, risk management or market-making services to the foregoing entities."

In the preamble of the applicable Federal Register release, the Commission's only comment in the text on this type of DTF noted that "[t]his type of eligible commercials-only market structure lessens many of the regulatory concerns regarding manipulation present with contracts for tangible commodities."

The term "dealer" is not otherwise defined in proposed new Part 37, nor is this term defined elsewhere in the Commission's regulations. In analyzing the structure of the definition, the definition expressly requires other entities to have the capacity to make and take delivery, but does not expressly impose this requirement on a dealer. Thus, it would appear that while these markets are being allowed because of the lessened concerns regarding manipulation, dealers are in effect being exempted from the delivery capability requirement because of the perceived value of the other services that the dealer provides to the other participants in that market, namely hedging, risk management or market-making services.

Local market makers work in a professional capacity to provide these same services for exchange-traded contracts. Thus, it would seem that local liquidity providers should be deemed to fall within this dealer carve-out from the otherwise generally applicable conditions of this definition. However, NYMEX staff has received some indication from Commission staff that the reference to a dealer was not intended to include professional local market makers.

The basis for such an exclusion is unclear. There would appear to be little dispute that permitting local market makers to trade on such a facility would add liquidity to the market, would make the market more competitive and thus generally should narrow the bid-ask spread for the products traded on that DTF. Consequently, from NYMEX's perspective, allowing local liquidity providers to serve as market makers in this type of DTF would provide great benefit to the other market participants.

On a policy level, as noted previously, the sole policy concern referenced by the Commission in the release with respect to a commercials market was CFTC's historic concern with manipulation. As noted, though, it appears that a dealer would be exempted under the proposed definition from the requirement to make or take delivery. If professional local market makers are providing the same function, then the Exchange suggests that they should be treated in the same manner. Thus, the inclusion of local liquidity providers within this market making function would have no discernible negative impact upon manipulation concerns because neither locals nor dealers would be participating in the delivery process. [8] Indeed, making the market price a more competitive price would be expected to further lessen the regulatory concerns associated with possible manipulation.

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8 In this regard, NYMEX currently employs a presumption in its energy markets today that locals are not eligible to stand for delivery. A local may overcome the presumption by demonstrating that the local has taken all necessary steps to make or take delivery, e.g., rental of storage facilities, payment of applicable licenses and taxes, etc.

There is some indication in the preamble of the applicable Federal Register release that this commercial market was designed with a particular business model in mind. [9] However, the fact that this commercial market approach to obtaining status as a DTF would accommodate one particular business model should not be used to exclude another business model that is generally comparable but for the sharing of market making responsibilities among a group of professional market makers rather than concentration of this function in a single dealer. In the preamble of the applicable Federal Register release, the Commission announced that "[t]he new framework provides U.S. futures exchanges the flexibility to respond to these [competitive] challenges by offering a level of regulation tailored to three alternative types of markets." As the Commission later noted, "[t]he business choice would be theirs."

NYMEX believes strongly that a Commission approach that unnecessarily restricted the scope of this market making function has the potential both to hinder innovation and to restrict competition in these markets. During the public hearings that were held at the CFTC in late June on the Reform Proposal, the Commission heard testimony from a number of industry experts, including testimony from Mr. Thomas Russo. [10] In his testimony to the CFTC, Mr. Russo cautioned the Commission against engaging in unnecessary labeling. [11] Rather than attach a particular label to the market making function, the Exchange respectfully suggests that the Commission focus instead upon the economic activity provided by persons or entities providing this service to the markets.

There may be some segments of the futures industry that might view any inclusion of local market makers in a market as akin to a traditional exchange. However, as regulated exchanges move into a demutualized environment, it may be appropriate to reconsider these traditional notions. In this regard, in securities markets, there has been a growing trend in recent years that has blurred the traditional distinctions between exchanges and broker-dealers, with certain new markets being regulated under the broker-dealer level of regulation. There is some basis for believing that the distinctions between FCMs and exchanges may also become blurred in the future as more intermediaries establish their own markets or establish stakes in existing markets. The profound changes that are underway in the futures industry may call for a more general consideration of an exchange. In other words, at its core, an exchange is simply a market that brings buyers and sellers together.

NYMEX believes that in this area, as in other areas, competition may well be the best regulator. Accordingly, the Exchange urges the Commission to revise its definition or otherwise clarify that professional local market makers who may meet the financial wherewithal or

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9 For example, in footnote 11 of the applicable release, the Commission stated that "[m]any of these trading facilities are expected to replicate electronically various aspects of today's commercial markets, including trading exclusively between principals, and direct negotiation and documentation of trades. In addition, these facilities often do not provide clearing arrangements for contracts."

10 Mr. Russo is Vice Chairman and Chief Legal Officer at Lehman Brothers and former director of the CFTC's Division of Trading and Markets.

11 Transcript, Volume I of a Public Hearing on a New Regulatory Framework, Tuesday, June 27, 2000, p.34. While Mr. Russo's point appeared to be directed at labeling of products, the same reasoning also would apply in this instance to the categorization of market makers.

guarantee requirements discussed in a prior section of this letter may serve the market making function in a commercials market approach to obtaining status as a DTF. [12]

5. Other Comments on Derivatives Transaction Facilities

As noted, the Reform Proposal would permit a facility to apply for DTF status on a case-by-case basis. The Exchange appreciates being provided the opportunity to apply for DTF status on this basis. In addition, the Exchange supports such DTF markets being given the flexibility to make their own determinations as to whether or not to permit retail participation in their markets. Retail participation could benefit the market by adding more trading volume and liquidity and could benefit retail customers by giving them access to markets that presumably would provide competitive bid-ask spreads.

While the Exchange generally supports the Core Principles that have been proposed for DTFs, the Exchange is concerned by one section of Appendix A to Part 37, which provides guidance on these Core Principles. Specifically, with respect to guidance on Core Principle #6, the Commission states that "Commission rule 1.31 is *the* acceptable practice regarding the form and manner for keeping records." [13] The word "the" arguably may be interpreted to indicate that Rule 1.31 is the only acceptable guideline to follow and thus would be inconsistent with discussion in the preamble stating that the appendices are intended to provide non-exclusive guidance on acceptable practices. Thus, at a minimum, a more appropriate wording might read, "Commission Rule 1.31 constitutes *an acceptable but non- exclusive means* regarding the form and manner for keeping records."

On a more general level, Rule 1.31 adopts an unnecessarily complex, restrictive and bureaucratic approach to the use of electronic media. Among other things, the Commission requires that persons who use only electronic storage media to preserve some or all of their required records must enter into an agreement with a third party technical consultant who would submit undertakings to the Commission. This is a burdensome and expensive proposal that would require recordkeepers who use only electronic storage media to hire a third party to have access to and the ability to download data, even if they have the capability of performing these functions in-house. The Commission already requires that recordkeepers maintain, keep current, and make available to CFTC staff all information necessary to access records that are kept on electronic storage media. The requirement of a third party is duplicative of this

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12 The Exchange notes that although the proposed definition for eligible commercial participant would only include a subset of the entities specified as eligible swap participants for purposes of Part 35, the Federal Register release provides no discussion concerning how the Commission selected that particular subset of entities from Part 35. Thus, the definition would include, among other entities, banks and insurance companies but would not include investment companies and commodity pools. Yet there is no explanation of the policy rationale for the omission of investment companies and commodity pools from this definition. Absent such a principled rationale, the Exchange would suggest a fair competition policy would support an approach that would allow all eligible participants under Part 35 to have an opportunity to demonstrate the delivery capability also specified in the definition for eligible commercial participant.

13 The same concerns addressed to this Core Principle apply equally to the guidance provided in the release for Core Principle #14 (Recordkeeping) of the Core Principles governing RFEs.

provision, and a disincentive to storing records electronically. NYMEX staff recently checked with CFTC staff and confirmed that these burdensome procedures have been used by only one registrant since the adoption by the CFTC of the revisions to Rule 1.31.

In sum, Rule 1.31 has some serious shortcomings, which would significantly undermine the improvements attempted by the Core Principles. While NYMEX continues to support the requirement that records be retained for five years, the Exchange suggests that the Commission revising its recordkeeping Core Principle or, alternatively, the guidance applicable under this principle, along the lines of the approach that has been suggested previously by the National Futures Association, which would provide for uniform general performance standards of reliability, accessibility, and security for all required records.[14]

III. A New Regulatory Framework for Clearing Organizations

Except as otherwise noted below, NYMEX generally supports the regulatory framework that the Commission has proposed for clearing organizations. NYMEX's experience has been that clearing, credit enhancement, guarantees, netting and like services perform very valuable functions in the marketplace. They increase transparency, reduce systemic risk, and increase the liquidity of the market overall. The regulatory framework that has been proposed would generally rationalize and make clear a number of requirements that have been applied by Commission staff to clearing organizations in recent years.

NYMEX agrees with the use of Core Principles in this area, and it is NYMEX's view that the fourteen Core Principles that have been proposed by the Commission, as modified by amendments suggested in discussions with CFTC staff, would constitute prudent financial safeguards that should be applicable to a facility offering a credit enhancement function.[15] NYMEX also believes that these Core Principles generally have been appropriately worded to constitute reasonable performance standards.

It has been suggested that the proposed Core Principles should be applicable only to new clearing organizations that have not operated under the current regulatory regime. The Exchange believes that the need for uniform standards in this area generally outweighs exemption or "grandfathering" of existing clearing organizations from the new requirements.

NYMEX also appreciates other changes included in the Reform Proposal that would

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14 In this regard, NYMEX notes that a number of acceptable practices applicable to RFEs still need to be supplied by the Commission. The Exchange looks forward to a future opportunity to comment on those practices.

15 Thus, it would be useful to clarify that proposed new Rule 39.2 (Fraud and Manipulation in Connection with Transactions Cleared by a Recognized Clearing Organization) would apply only with respect to fraud concerning the activity of the clearing of a transaction. In addition, NYMEX agrees with other commenters who have contended that the jurisdictional scope of proposed new Part 39 needs to be clarified further. In particular, the Commission needs to clarify the extent to which Part 39 would be applicable to the clearing of cash or forward transactions, which are not considered to be contracts for future delivery under the CEA. It is the Exchange's view that, at a minimum, the mere clearing of such transactions should not thereby result in making these transactions subject to the jurisdiction of the Commission.

provide flexibility to markets in organizing their clearing businesses. Thus, for example, the proposal confirms that a clearing organization need not be affiliated with an exchange. In addition, a clearing organization would not be restricted from clearing any other type of cash or derivative instrument. Moreover, while a clearing organization must file rule changes with the Commission, it may self-certify that the rule change complies with the CEA; thus, there would be no prior approval requirement.

Proposed new Rule 39.2 (Permitted Clearing) would provide that transactions effected on a designated contract market, recognized futures exchange, or derivatives transaction facility, if cleared, could be cleared only by a recognized clearing organization regulated by the CFTC. By comparison, a transaction effected pursuant to Part 35 (clearing of swaps) or Part 36 (clearing of products traded on an exempt MTEF) , if cleared, could also be cleared by any of the following: a securities clearing agency, a bank clearing system or a foreign clearing organization. A foreign clearing organization would need to demonstrate to the Commission that it:

"(i) is subject to home country regulation and oversight comparable to the standards set forth by the Commission for recognition of clearing organizations under this part; and

(ii) is a party to and abides by appropriate and adequate information-sharing arrangements.

NYMEX does not object to the general structure of this proposed rule. However, the Exchange recommends that the Commission, in order to offer a transparent regulatory process, clarify the standards under which a foreign clearing organization will be deemed to operate under comparable requirements. In addition, the Exchange recommends that the Commission provide that such information-sharing arrangements extend not only to domestic regulators but also to domestic clearing organizations who would be affected by the products cleared by the foreign clearing organization.

A. Maintenance of Prescriptive Rules for Certain Financial Requirements

While the Exchange, as noted above, generally supports the use of Core Principles, the Exchange also believes that certain requirements, such as those that would be covered by Core Principle #5 (Treatment of Client Funds) and Core Principle #6 (Default Rules and Procedures) are more appropriately addressed with specific rules providing sufficient detail to allow market participants to assess their rights and responsibilities. Clarity regarding these types of obligations raises systemic concerns because they also concern an assessment of the risks faced by the clearing organization.

Market participants submitting trades for clearing will need to determine precisely their applicable rights, including their right of offset and their rights in bankruptcy. Therefore, the Exchange believes that it is important that the clearing rules provide sufficient precision because they in effect establish the risk that a participant in the market is taking beyond just the market risk that exists in the instruments traded.

The regulatory treatment within the same legal entity of instruments that are regulated with instruments that are exempt from regulation is an additional area that will require more precise definition. The Exchange believes that there are existing analogies in OTC and in exchange-traded markets that can be analyzed and brought to bear on these issues. In this

regard, the Exchange would be willing to participate in any appropriate forum to contribute to the development of these rules.

B. Discussion of Proposed Definition for Clearing Organization

Under proposed new Part 39, the CFTC proposes to define a "clearing organization" as a person, entity or association that performs a credit enhancement function in connection with transactions executed on a designated contract market or pursuant to Parts 35-38 by becoming a universal counterparty to market participants or by operating a facility for the netting of obligations and payments of such transactions. . . " The reference to universal counterparty in this definition is consistent with how certain overseas clearing organizations, such as in London, have operated. In other words, these overseas clearing organization could reasonably be viewed as being a counterparty in every transaction.

There is a catch phrase in the futures industry that a clearing organization acts as the "buyer to every seller and the seller to every buyer." However, the reference to universal counterparty is a bit different from NYMEX's understanding of how futures clearing organizations in this country have typically operated. At NYMEX, for example, in the event that a seller defaulted on its obligation to deliver a commodity, and the seller's clearing member also defaulted, NYMEX's Clearing House could be viewed as stepping into the place of the seller's clearing member by supplying the buyer's clearing member with a measure of financial performance (to be passed along to the buyer) that otherwise would have been supplied by that clearing member. By contrast, the Exchange would not undertake to provide physical delivery of the commodity. NYMEX's point here is simply to observe that the Clearing House's relationship is with the clearing members rather than with the ultimate buyers and sellers. Thus, the CFTC may wish to consider revising its definition accordingly.

The CFTC's proposed definition for clearing organization would exclude those netting arrangements specified in Rule 35.2(d)(1) and (d)(2), which pertain to the netting of payments and the netting of payment obligations. NYMEX believes that this is a reasonable exclusion. The definition also would exclude an entity that is a single counterparty offering to enter into, or entering into, bilateral transactions with multiple counterparties. While noting the possibility that there could be some concentration of positions in such an entity, NYMEX also believes that it is appropriate to exclude such an entity from the definition for a clearing organization.

C. Providing Requested Comment on Opting Out of Segregation

The Commission did not make a specific proposal, but did request comment concerning whether customers should be allowed to "opt out" of the rules requiring segregation of customer funds. NYMEX believes that the protections provided by segregation of funds are not strictly necessary for certain types of customers, such as institutional market participants. Therefore, NYMEX believes that the Commission should consider permitting certain customers to have the opportunity to opt out of segregation under appropriate circumstances. The effects of similar practices in other jurisdictions need to be researched fully. However, NYMEX is aware that other regulatory regimes overseas do permit opting out of segregation in certain instances.

NYMEX suggests that, at least initially, this option should be limited to the accounts of institutional customers. Such an approach would be consistent with the Commission's approach taken in other areas of recognizing the capitalization and/or sophistication of some market participants in assessing the extent of federal regulatory protection needed by such participants.

Because the FCM or other entity accepting the customer's funds presumably would continue to act in a fiduciary capacity with regard to such funds, NYMEX suggests that it would be appropriate for the funds to be held in a relatively secure depository, such as with a bank, a clearing house, or another FCM. In view of the fiduciary relationship involved, NYMEX's preliminary view is that there should be some type of minimum capital requirements. The method and level of such a requirement would be a topic for further discussion. One possibility would be to establish a minimum capital requirement that is a percentage of the capital held by that firm.

In NYMEX's view, an institutional participant that is willing to opt out of segregation has in essence made a business decision that it has calculated and is willing to accept a marginally higher level of risk associated with opting out of segregation. NYMEX's present view is that it would be inconsistent with that business judgment and with the rationale underlying the opt-out opportunity to then permit such a company to have preferential treatment in bankruptcy, either under Part 190 of the CFTC's rules or under the Bankruptcy Code. It would be the Exchange's view that such an institutional participant should be treated as a general creditor in bankruptcy. In this way, it is NYMEX's understanding that such a market participant would receive treatment that would be analogous to that of principals of the bankrupt FCM who had traded through the FCM or to that of an affiliate of the FCM who had traded through the FCM on the house side.

NYMEX thinks that it is critically important that institutional participants who elect to opt out of segregation do so only after being fully informed of the consequences of such an action. Thus, it is important that an FCM should be required to disclose fully the risks associated with opting out, such as the different treatment in a bankruptcy context noted above.

D. Providing Requested Comment on Permitting FCMs to Maintain a Broader Mix of Products in the same Customer Segregated Account at both the FCM and Clearing House Level

In the CFTC's regulatory reform proposal, the Commission also requested comment on whether FCMs should be allowed to maintain, in the same customer segregated account, funds used for the purpose of securing or margining instruments other than those currently permitted. NYMEX believes that such practices, at least initially, should be limited to the accounts of institutional customers, and as discussed above, NYMEX does support permitting such customers to have the opportunity to opt out of segregation.

NYMEX believes that there should be some type of capital calculation for such products. In view of the nature of some of the products that would be contained within the same account, one possible approach would be to make a risk-based capital assessment. In this regard, it is worth noting that while the level of risk associated with different types of products will vary, there are also potential benefits to clearing members in the event that different types of assets would be maintained in the same account. For example, at present, a company may execute an OTC transaction and then hedge that position with a futures contract. A clearing member currently is somewhat limited in the information that is available regarding the OTC product. If both products were held in the same account, the clearing member would appear to be in a better position to see and assess both sides of this activity. Also, if both assets are held in the same account, the decline in value of one asset should generally be offset by the increase in value of the other asset. Thus, combining both assets in the same account has the potential to reduce risks for the clearing member.

The treatment of such accounts in bankruptcy and the effects of similar practices in other jurisdictions should be topics for further review. Again, an FCM should be required to disclose fully to institutional participants the risks associated with combining various assets in the same account, including any different treatment in a bankruptcy context.

E. Proposed Amendments to CFTC Rule 1.25

In the Federal Register release directed at changes primarily applicable to intermediaries, the Commission proposed to expand the range of instruments in which FCMs and clearing organizations may invest customer funds. Specifically, the Commission is proposing to amend Rule 1.25, which sets forth the types of instruments in which FCMs and clearing organizations are permitted to invest cash segregated for the benefit of regulated commodity customers pursuant to Section 4d(2) of the CEA. Because of the impact on clearing organizations, the Exchange also is providing comments on this proposal.

Currently, Rule 1.25 permits a FCM or clearing organization to invest segregated funds only in obligations of the U.S., in general obligations of any State or of any political subdivision thereof, or in obligations fully guaranteed as to principal and interest by the U.S. The Commission indicated in its proposal its belief that an expanded list of permitted investments could enhance the yield available to FCMs, clearing organizations and their customers, without compromising the safety of customer funds.

NYMEX does not oppose the expansion of investments proposed by the Commission and appreciates the additional flexibility that this expansion would provide. Ultimately, of course, each clearing organization would need to make its own determination as to the types of assets that would be accepted by that clearing organization. Because there will likely be a real variety in the coming years in the types of credit enhancements provided by clearing organizations, the analyses undertaken by individual clearing organizations may vary somewhat. One consideration that existing clearing entities likely would take into account with regard to a particular asset would be the speed with which the asset could be converted into cash.

IV. Rules Relating to Intermediaries of Commodity Interest Transactions

The Reform Proposal includes a number of changes directed at intermediaries, such as FCMs. For example, the CFTC is proposing to simplify certain registration requirements. The Commission is also proposing to amend the definition of the term "principal" in CFTC rules, mainly to eliminate inclusion of certain types of officers of a firm. In addition, account opening procedures would be simplified to allow for all required disclosures (with the exception of arbitration agreements) to be acknowledged with a single signature, which may be an electronic signature. Also, the obligation for FCMs and introducing brokers to provide a specific disclosure statement would be eliminated for a greater number of sophisticated customers. The Exchange find that these and other proposed changes in this release generally would be reasonable and appropriate amendments to existing rules.

In the applicable release, the Commission advanced a number of Core Principles applicable to intermediaries. However, the CFTC stated that rather than replacing its existing rules, these Core Principles would be used to assist the Commission in developing its regulatory policy with respect to intermediaries. Some members of the FCM community have argued that the Commission should reexamine its rules applicable to intermediaries with the goal of

replacing them with a set of Core Principles and acceptable practices. With the exception of certain financial rules, where precision and clarity really require detailed rules, NYMEX encourages the Commission to reexamine other rules, such as recordkeeping requirements, where general performance standards would be more appropriate.

However, this process would require an intensive review of the applicable rules in this area. Therefore, the Exchange cautions the Commission that undertaking such an examination as part of the current Reform Proposal could so greatly lengthen the process as to undermine the entire reform effort. Accordingly, such review should be undertaken pursuant to a separate reform initiative.

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NYMEX thanks the Commission for the opportunity to submit comments concerning its Reform Proposal and would be pleased to furnish additional information in this regard. If you have any questions, please do not hesitate to contact the undersigned.

Respectfully submitted,

Neal L. Wolkoff
Executive Vice President

cc: Chairman William J. Rainer
Commissioner Thomas J. Erickson
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