COMMENT

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CHICAGO MERCANTILE EXCHANGE INC.

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April 9, 2001

Ms. Jean A. Webb
Office of the Secretariat
COMMODITY FUTURES TRADING COMMISSION
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Commodity Futures Modernization Act of 2000 and the New Regulatory Framework – Regulatory Reinvention, 66 *Fed. Reg.* 14262 (March 9, 2001)

Dear Ms. Webb:

Chicago Mercantile Exchange Inc. ("CME") is pleased to offer these comments on a proposal recently published by the Commission regarding rules designed to implement the Commodity Futures Modernization Act of 2000 ("CFMA") and the Commission's new regulatory framework. CME strongly supports the Commission's promised move from a direct regulator to an oversight regulator, replacing prescriptive rules with broad performance standards in the form of core principles. CME applauds the Commission's flexibility in the area of rule submissions and approvals. In particular, we believe that allowing designated contract markets ("DCMs") to request that the Commission provide approval of rules and products at any time, even after their implementation, will strengthen the ability of DCMs to compete in the global marketplace.

While CME supports the objectives and many of the rulemaking proposals, we believe that certain aspects of the proposals do not represent the best means of accomplishing those objectives. Our comments below will focus on certain areas where we think the proposals could be improved.

I. INTRODUCTION

The Commodity Exchange Act ("Act"), as amended by the CFMA, establishes two tiers of regulated markets, DCMs and registered derivatives transaction execution facilities ("DTFs"). The revised Act also provides for two markets exempt from regulation, exempt boards of trade ("EBOTs") and exempt commercial markets.

The categories of markets can be broadly distinguished as follows. Futures and futures options on virtually any product can be traded on a DCM, and any person is eligible to trade on such a market. DCMs are subject to eighteen core principles. Existing U.S. futures exchanges would automatically qualify to become DCMs. Markets operated as DTFs would be subject to an intermediate level of regulation consisting of nine core principles. DTFs can trade derivatives on specified types of commodities that have a low susceptibility to manipulation. In addition, a facility that restricts participation to "eligible commercial participants" trading for their own accounts would be eligible to become a DTF to trade contracts based on any commodities except those agricultural commodities enumerated in Section 1a(4) of the Act.

The two markets that are exempt from regulatory oversight by the Commission are exempt commercial markets and EBOTs. Exempt commercial markets only allow eligible commercial entities to enter into derivatives transactions in exempt commodities that are traded on an electronic trading facility. EBOTs can trade futures on specified types of commodities that are highly unlikely to be susceptible to manipulation. Only eligible contract participants would be allowed to participate in such transactions. Exempt commercial markets and EBOTs would be exempt from all of the requirements of the Act, except for anti-fraud and anti-manipulation provisions. Exempt commercial markets and EBOTs can not hold themselves out as being regulated, licensed or approved by the Commission.

II. DESIGNATED CONTRACT MARKETS

Existing U.S. futures exchanges automatically qualify to become DCMs with respect to all of their previously designated contracts. These exchanges can operate both open-outcry and electronic markets. Transactions executed on a DCM must be cleared by a clearinghouse authorized by the Commission under Part 39.

The most significant aspect of the proposed regulatory restructuring is the replacement of the CFTC's detailed, prescriptive regulations with more flexible core principles. An entity that is regulated as a DCM would be subject to 18 core principles, ranging from a requirement to monitor and enforce its rules to an admonition to avoid unreasonable burdens on competition not necessary or appropriate in furtherance of the objectives of the Act. CME strongly supports the Commission's approach in moving from prescriptive regulations to core principles. However, we note that many of the core principles are general in nature and susceptible to different interpretations. It is likely that there will be occasions when a DCM will take a particular action that it believes to be consistent with the core principles, but that the Commission or its staff might disagree. We believe that it would be desirable to provide a mechanism for resolving such disagreements short of the Commission taking punitive action against the DCM.

Under the proposed rules, the Commission would retain the authority to stay the effectiveness of a rule implemented by a DCM during the pendency of a proceeding to disapprove, alter or amend the rule. CME believes that rules adopted by an exchange should be presumed to be lawful and valid. We therefore believe that the Commission should not seek to

stay the operation of an exchange rule simply because disapproval proceedings have been initiated. In an emergency situation, the Commission has authority under Section 8a(9) of the Act to direct an exchange "to take such action as in the Commission's judgment is necessary to maintain or restore orderly trading in or liquidation of any futures contract . . . ." The Commission can take such action without providing advance notice or a hearing.

Section 38.3(b)(2) of the proposed regulations requires a DCM to provide "fair, equitable and timely availability to market participants of information regarding prices, bids and offers." There is no support for this requirement in CFMA or previous legislation. Section 5(b)(3) of CFMA requires fair and equitable trading and section 5(c)(8) requires daily publication of trading information. Neither of these can be reasonably stretched to require the public dissemination of all prices, bids, and offers. While CME agrees with this requirement in concept, we want to confirm that the procedures currently employed by the Exchange – which are in complete accord with prior law, rules, and regulations – comply with the proposed standard. The procedure used by CME in most trading pits is to disseminate bids and offers when they are better than the previous price. Accordingly, bids and offers that are not "better" than the previous price are not disseminated. In addition, for spread trades, only actual transaction prices are disseminated. CME believes that its long-standing procedures regarding price dissemination satisfy the requirement of fair and timely availability of information to market participants and have been embraced and accepted by customers and the industry as a whole. This same provision regarding the dissemination of market information, and the above discussion, are also applicable to parallel rules regarding DTFs.

An area of paramount concern to CME is the Commission's apparent attempt to become more involved in establishing and/or monitoring of appropriate performance bond (margin) levels for Exchange contracts. In Designation Criteria 5(b)(5) (Financial Integrity of Transactions), CFMA requires a DCM to provide for the financial integrity of transactions, including the clearance and settlement thereof by a DCO. Section 5b of CFMA establishes requirements for DCOs. It contains specific requirements for financial resources, participant and product eligibility, risk management, settlement procedures, treatment of funds, default rules and procedures, rule enforcement, system safeguards, reporting, recordkeeping, public information, information-sharing, and antitrust considerations, but does not mention margins. The Commission has express emergency authority to increase margins, and has been delegated authority by the Federal Reserve to administer margins for broad-based stock index futures and futures options. That is the extent of the Commission's authority with respect to margins. CFMA allows exchanges considerable flexibility in developing appropriate risk management procedures, and it is conceivable that innovation will produce procedures that do not rely on the collection of margin as it is known today. The Commission's proposed regulations appear to have the potential to freeze risk management practices as they exist today.

Further, CME believes that it would be inappropriate for the Commission to become involved in CME's procedures for setting margin levels. CME has a great deal of experience in setting appropriate margin levels for its contracts and has done so in a prudent and effective way

for many years. Margin levels need to be set in such a way that they are not too low, which may become problematic for the Exchange's risk management, or too high, which may have the effect of deterring trading in the product. CME has been successful in finding the correct balance for its contracts.

The Commission's stated role as an oversight regulator and less of a direct regulator would argue that it should be less involved in the day-to-day operations of the entities that it regulates. Since the Commission has not had direct involvement in the margin practices of CME in the past, and since the Commission has emergency authority to increase margins, it should not attempt to take on such a role now.

III. DESIGNATED TRANSACTION EXECUTION FACILITIES

Markets operated as DTFs would be subject to an intermediate level of regulation consisting of nine core principles. DTFs can trade specified types of commodities that have a low susceptibility to manipulation. In addition, a facility that restricts participation to "eligible commercial participants" could become a DTF to trade contracts based on a broader range of commodities.

As noted above, a facility that restricts participation to "eligible commercial participants" that trade for their own account would be eligible to become a DTF to trade contracts based on any commodities other than the enumerated domestic agricultural products. CME believes that, so long as participation in the market is limited to eligible participants, they should be allowed to trade any commodity through a DTF, including domestic agricultural products.

DTF Core Principle 4 (Disclosure of General Information) provides that a board of trade operating as a DTF should have arrangements and resources for the disclosure and explanation of contract terms and conditions, trading conventions, trading practices, systems functioning, system capacity, system security, system testing and review and financial integrity protections. CME believes that it is counter productive to require the disclosure and explanation of system security. Such a disclosure could provide certain individuals with sensitive information so they could probe for weaknesses in such security systems and potentially damage the DTFs systems. Accordingly, CME does not deem it advisable for such system security information to be subject to disclosure.

IV. MISCELLANEOUS PROVISIONS

The definition of "Emergency" in Part 40 means, in addition to other circumstances, "any action taken by any governmental body, or any other board of trade, market or facility which may have a direct impact on trading on the trading facility." CME believes that this definition is too broad and problematic because it would appear to require the declaration of an emergency if, for example, the Federal Reserve changes the fed funds rate when there is an impact on trading at CME. In addition, it is not clear what a direct impact by another "board of trade, market or

facility" means. Would CME be required to declare an emergency and shut down if the CBOT closes for business and CME experiences a sudden influx of Eurodollar business?

Section 40.6 addresses self-certification of rules by DCMs and DFTs. Section 40.6(a)(2) provides that a DCM or DTF may implement a new rule or rule amendment so long as the submission for the rule or rule amendment is received by the Commission by close of business on the business day proceeding implementation of the rule; provided, however, such rules implemented under procedures of the governing board to respond to an emergency must be filed with the Commission at the time of implementation of the rule or rule amendment, if implementation is sooner than the next business day.

This provision more closely resembles micromanagement than oversight. It has the effect of requiring a DTF to concern itself with an administrative procedure rather than concentrating on the emergency itself. As such, CME believes that this provision should be deleted in its entirety or, if not deleted, further relaxed to allow for notification and submission to the Commission within five days of the implementation of the emergency rule.

Proposed Part 40 retains special paperwork for amendments to so-called dormant contracts; i.e., those that have been listed for at least five years and have not traded for six months. This requirement appears to be a relic of the days of more intensive regulatory administration. CME questions what benefit this requirement brings and whether it outweighs the attendant administrative burden.

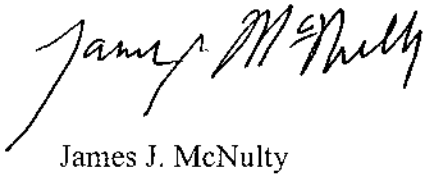
Part 40 also retains, with respect to delivery standards and to index constructions and calculations, distinctions between in-house changes and those made by independent third parties. CME believes that there are sufficient safeguards embodied in the Core Principals to make requirements at this level of detail obsolete.

CME believes that proposed section 166.5 (Dispute Settlement Procedures) that discusses arbitration procedures for customers is out of step with current dispute resolution practices because it makes arbitration a voluntary procedure for customers. Proposed section 166.5 states that when customers are requested by a Commission registrant to sign an agreement outlining dispute resolution procedures, such customers must be offered three forums in which they may resolve any commodity disputes; civil court litigation, CFTC reparations, or an arbitration conducted by an SRO or other private organization.

In recent years, the securities industry, courts and Congress have expressed a preference for arbitration as a quick and efficient procedure for resolving many types of disputes brought by customers or claimants. Arbitration proceedings are much quicker and more economical than the court system, which is beneficial to all parties involved. In addition, the trier of fact making decisions in arbitration proceedings consists of industry experts that will ultimately result in more consistent and appropriate decisions. For these reasons, we believe that customers should have disputes arising out of transactions on a DCM or DTEF resolved by arbitration panels

created by such DCM or DTEF. In addition, reparation actions, which closely resemble arbitration actions, are also a satisfactory forum for customer disputes.

Respectfully submitted,



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