



New York Mercantile Exchange

NYMEX/COMEX. Two divisions, one marketplace

May 23, 2002

VIA FACSIMILE AND EXPRESS MAIL

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

Re: Request for Commission Determination Concerning Eligible Contract Participants and Eligible Commercial Entities

Dear Ms. Webb:

By letter dated April 24, 2002, the New York Mercantile Exchange, Inc. ("NYMEX" or the "Exchange") submitted a request for a determination by the Commodity Futures Trading Commission ("CFTC" or "Commission"). Specifically, the Exchange requested that the Commission make a determination pursuant to Section 1a(12)(C) of the Commodity Exchange Act ("Act") in connection with the scope of the term "eligible contract participant" as the term applies to NYMEX Floor Members.

The Exchange has determined to modify the scope of the requested determination. Accordingly, the purpose of this letter is to advise the Commission that the Exchange is withdrawing the petition submitted on April 24, 2002 and is submitting a new petition that is included as an attachment to this letter.

The new, attached petition requests a Commission determination pursuant to Section 1a(12)(C) and also Section 1a(11)(C) of the Act, which concerns the scope of the term "eligible commercial entity." On the other hand, the new petition clarifies that the requested determination generally would limit trading by NYMEX Floor Members to trading only in OTC contracts that would be subsequently be cleared at the Exchange. However, the requested determination also would provide that NYMEX Floor Members not be permitted to engage in trading in OTC electricity contracts.

We appreciate the Commission's consideration of this request and look forward to working with the Commission and Commission staff on this filing. As a note, in discussions with CFTC staff, it is our understanding that the Commission at some point may determine to publish for public comment its proposed response, and the Exchange wishes to make clear that it would be supportive of such an

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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, palladium, and the FTSE Eurotop 300[®] index. The COMEX Division offers trading in gold, silver, copper, aluminum, and the FTSE Eurotop 100[®] index.

Ms. Jean A. Webb
May 23, 2002
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approach. If you have any questions, please do not hesitate to contact the undersigned.

Respectfully submitted,


Brian J. Regan
Senior Associate General Counsel

Att.

cc: Chairman James E. Newsome
Commissioner Thomas J. Erickson
Commissioner Barbara P. Holum
Duane Andresen

**Petition for Commission Interpretations
Pursuant to Section 1a(11)(C) and
Section 1a(12)(C) of
the Commodity Exchange Act**

I. Introduction

As amended by the Commodity Futures Modernization Act of 2000 ("CFMA"), the Commodity Exchange Act ("Act") now includes a definition for "eligible commercial entity" ("ECE") in Section 1a(11) of the Act and a definition for "eligible contract participant" ("ECP") in Section 1a(12) of the Act. The scope of the definition for ECE is significant for purposes of this petition because this statutory term determines the entities and individuals who are eligible to enter into transactions on an electronic trading facility offering trading in an "exempt commodity" pursuant to the exemption provided for such facilities in Subsections 2(h)(3)-(5) of the Act. An exempt commodity is defined by the Act to refer to a commodity that is not an excluded commodity or an agricultural commodity; the scope of the term exempt commodity thus generally includes energy and metals products.

The scope of the definition for ECP is important for purposes of this petition because this statutory term determines the entities and individuals who are eligible to enter into transactions not executed or traded on a "trading facility" in an "exempt commodity".¹

The New York Mercantile Exchange, Inc. ("NYMEX" or "Exchange") is petitioning the Commission to issue a determination regarding the scope of the ECE definition as applied to NYMEX floor brokers and floor traders. As a note, the ECE definition by its terms does not expressly refer to such Commission registrants. However, subsection (C) of that definition provides the Commission with express authority to include within that definition "such other persons that the Commission shall determine appropriate and shall designate by rule, regulation or order."

The definition for ECP does designate floor traders and floor brokers as ECPs. However, there is some uncertainty as to the ability of floor brokers and floor traders to enter into transactions not executed on a registered entity. Subsection 1a(12)(A)(x) provides that floor brokers and floor traders are eligible contract participants "in connection with any transaction that takes place on or through the facilities of a registered entity or an exempt board of trade, or any affiliate thereof, on which such person regularly trades. The Act does not further define or clarify what is meant by "in connection with" a transaction that "takes place on or through the facilities of" a specified facility.

Consequently, one interpretation is that the Act does not expressly provide for floor traders and floor brokers (who are operating their businesses as natural persons) to enter into bilateral, individually negotiated over-the-counter ("OTC") transactions. But the Act does not expressly bar such activity either.

¹ Of course, eligible contract participants also are eligible to enter into bilateral transactions in an "excluded commodity", but such activity falls outside the scope of the Commission determination requested in this petition.

At present, it would appear that such Commission registrants may only participate in such transactions if they meet one of the two total assets tests specified in Section 1a(12)(A)(xi).² In addition, though, the ECP definition grants discretion to the Commission to expand the category of ECPs when deemed appropriate. Specifically, Subparagraph (C) of Section 1a(12) provides that the scope of eligible contract participants also shall include any other person that the Commodity Futures Trading Commission ("Commission") "determines to be eligible in light of the financial or other qualifications of the person." This statutory provision thus gives the Commission broad authority to exercise its discretion to determine the eligibility of other persons. With respect to floor traders and floor brokers, who are Commission registrants, the financial guarantee provided by a futures commission merchant ("FCM"), which is also a Commission registrant, is a reasonable substitute for the total assets tests noted above in connection with OTC transactions for their own accounts in exempt and excluded commodities.

Accordingly, the Exchange, acting on behalf of Exchange Members who are registered with the Commission either as a floor trader or a floor broker (hereafter collectively referred to as "Floor Members"), requests that the Commission make a determination pursuant both to Section 1(a)(11)(C) and to Section 1a(12)(C) that Floor Members, when acting in a proprietary capacity, may enter into certain, specified OTC transactions in exempt commodities if such Commission registrants have obtained a financial guarantee for such trades from an Exchange Clearing Member who is registered with the Commission as a FCM. The Exchange is also making this request on behalf of Member Firm Clearing Members who would be providing such guarantees to Floor Members for the activity specified herein.

With respect to the OTC transactions that would be permissible under the determination petitioned by the Exchange, NYMEX suggests that such OTC transactions be limited to trading to in a commodity that either:

- (1) is listed only for clearing at the Exchange; or
- (2) is listed for trading and clearing at the Exchange and where Exchange rules provide for the exchange of futures for swaps in that contract.

Such trading could be undertaken either in the traditional bilateral OTC market or on an electronic trading facility where ECPs or ECEs (such an electronic trading facility exempted pursuant to Section 2(h)(3) of the Act) were eligible to trade on the system. Notwithstanding the above, the Exchange further suggests that the scope of permissible transactions in exempt commodities not include at this time any transactions in electricity commodities. Finally, such transactions also would be subject to the additional conditions and restrictions detailed in this filing.³

² Clause (xi) extends to any "individual who has total assets in an amount in excess of—
(I) \$10,000,000; or
(II) \$5,000,000 and who enters into the agreement, contract, or transaction in order to manage the risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred, by the individual."

³ As a note, it does not appear that Section 4(c) of the Act is directly applicable to this determination. Section 4(c), which was added to the Act pursuant to the Futures Trading Practices Act of 1992, applies to transactions that otherwise must be executed on a contract market or a derivatives transaction execution facility pursuant to Section 4(a) of the Act, whereas the term eligible contract participant is used in connection with defining participants for

II. Public Interest Considerations

To date, the Exchange has not identified any observable public costs that would be associated with the proposed action. Accordingly, the Exchange believes strongly that the benefits of the requested determination far outweigh any possible costs, and thus believes that the proposed action should easily pass review by the Commission pursuant to Section 15 (Consideration of Costs and Benefits and Antitrust Laws) of the Act. Section 15, as amended by Section 119 of the CFMA, requires the Commission to consider the costs and benefits of its action before issuing an order (or new regulation) under the Act. By its terms, Section 15 as amended does not require the Commission to quantify the costs and benefits of a new regulation or to determine whether the benefits of the regulation outweigh its costs. Rather, Section 15 simply requires the Commission to "consider the costs and benefits" of its action.

The amended Section 15 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. Thus, 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 order or rule 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.

The requested determination is best considered against the overall context of the connection between OTC and exchange markets. In general, the Exchange believes that it is good public policy for the Commission to permit ties between the OTC and exchange markets to be strengthened when it is possible to do so. Without diminishing the value of the role served by OTC markets, it is also clear, for example, that expanding and deepening these ties through use of the exchange of futures for swaps mechanism ("EFS") can facilitate the shift of extant transactions to the more transparent, cleared and regulated markets, providing benefits to all market participants. Indeed, in the wake of the failure of Enron last fall, the Exchange witnessed a dramatic increase in the use of EFS transactions to extinguish OTC positions and to create futures positions on the Exchange.

In addition, the Exchange has recently announced a number of initiatives intended to better serve the OTC community as part of its stated goal of making the Exchange the "one-stop shop for the entire energy industry." First, the Exchange has purchased the assets of a firm that provides software to generate electronic confirmations of OTC transactions. Second, last December, the Exchange launched a new cash-settled futures contract, whose material terms are the same as OTC "look-alike" versions of the Exchange's Natural Gas futures contract. Moreover, the Exchange has also announced that, commencing on May 31, 2002, it will launch a new product slate of contracts executed in OTC markets that will be listed only for clearing as futures contracts at the Exchange.

transactions not executed on such facilities. However, the Exchange believes that the requested determination is consistent with the spirit and purpose of Section 4(c), which is intended to "promote responsible economic or financial innovation and fair competition."

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The Exchange has concluded that the ability of its Floor Members, the liquidity providers at the Exchange, to trade OTC swaps pursuant to a FCM guarantee, particularly OTC energy and metals swaps, is a pivotal component of the Exchange's business strategy to better serve its customers. First, this capability would enhance the Floor Members' function in providing liquidity to NYMEX markets with regard to NYMEX's existing product slate.⁴ In recent years, it has become more and more important for Floor Members trading on the Exchange trading floor to monitor not only prices of transactions on other energy trading facilities but also to attempt to track transaction prices in the "upstairs" or OTC energy markets.

By being able to trade in such OTC markets, Floor Members will increase their access to trading information in such markets. This increased informational flow will assist Floor Members in maintaining the tightest possible bid-ask spreads with respect to products trading on the Exchange that compete or have strong price relationships with OTC products. In this regard, Congress arguably tacitly acknowledged the liquidity function provided by floor traders and floor brokers by including them as ECPs for purposes of trading on a registered entity (or exempt board of trade) on which they regularly trade.

Second, for the reasons stated above, this capability also will enhance the ability of Floor Members to make tight markets in the new products offered or to be offered by the Exchange that will compete against the standardized look-alike contracts now trading in OTC markets. In this regard, it is worth noting that it has been the Exchange's experience that 80-90% of energy swap transactions involve standardized economic terms. 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.

Third, with respect to both groups of NYMEX contracts, this capability will allow Floor Members to enter into EFS transactions with OTC counterparties. Floor Members would expand the pool of potential counterparties for an OTC market participant, thus facilitating liquidity in the OTC marketplace.

Finally, with respect to the clearing of OTC transactions at the Exchange commencing on May 31, 2002, the Exchange intends that the open positions in futures contracts created by the exchange of an OTC swap for a NYMEX future would be offset by an opposite transaction in the OTC market. The market participants using this service would clearly benefit from having a larger pool of market participants who would be willing either to enter into a transaction initiating or liquidating a position on the Exchange as the case may be.⁵

⁴Unlike 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. Hence, physical derivatives markets have a greater need for sources of liquidity other than from market participants hedging their own price risks. At the Exchange, Floor Members provide nearly one-half of the trading volume for many Exchange energy futures contracts.

⁵ For example, assume that an OTC market participant is the buyer in a Henry Hub (natural gas) swap transaction in the OTC market and that this transaction is thereafter exchanged via an EFS transaction for a long futures position in the Exchange's new Henry Hub Swap futures contract. This market participant could offset this position by acting as the seller in an OTC swap that would also be exchanged via an EFS transaction for a short position in this contract, thus

As a note, this OTC clearing service likely will offer cross margining and other potential benefits to market participants. Thus, commencing upon the launch of this new service, there will clearly be a significant additional advantage to market participants, including professional market makers such as NYMEX Floor Members, to have the opportunity to trade OTC as well as Exchange products.

The economic impact on OTC markets of allowing Floor Members to trade in such markets with a FCM guarantee is unambiguous: competition and efficiency would increase, price discovery would be enhanced, and liquidity risk that arises from artificial barriers to entry in these markets and the resultant increased market risk would decrease. NYMEX Floor Members as a group provide essential trading expertise to the market that enhances price discovery through both the speed and efficiency of market adjustment to new fundamentals.

Moreover, NYMEX Floor Members also have extensive experience with the Exchange's own electronic trading system, which has been in operation since 1993, and this experience would be directly translatable to trading on other electronic trading facilities offering trading in comparable energy and metals products.

NYMEX Floor Members have exceptional skills at interpreting market momentum, facilitating the near-instantaneous adjustment of the market price to new information, as well as at spread trading between related markets-- essentially a derivative form of arbitrage-- which ensures rapid adjustment of all relevant market prices beyond the primary market as well. It is axiomatic that Floor Members participating in OTC markets would perform precisely these functions, with each function benefiting the competitiveness of the OTC market. The artificial regulatory barriers to Floor Members participating in OTC markets have simply resulted in diminishing the overall robustness of those markets.

The Exchange suggests that the specific cost-benefit factors that must be analyzed by the Commission could be assessed as follows.

1. Protection of market participants and the public. In general, the proposed CFTC determination of Floor Members' eligibility would be expected to cost little in terms of diminishing the protection of market participants and the public. Under the Act, eligible contract participants for OTC transactions involve sophisticated investors with the financial wherewithal to participate in these markets. As a prudential matter, the Exchange is proposing as part of the requested Commission action certain conditions and restrictions that are discussed in a later section.

2. Efficiency and competition. As detailed above, the proposed determination would be expected to provide benefits in increased competition and increased market efficiency in Exchange markets and in OTC markets as well.

3. Financial integrity of futures markets and price discovery. The proposed determination should have no effect, from the standpoint of imposing costs or creating benefits, on the financial integrity of the futures and options markets or on the risk management practices of FCMs. The proposed determination may have a favorable effect in creating benefits with regard to the price discovery function of the futures and options markets.

offsetting the existing position.

As to FCM risk management practices, FCMs are in the business of, and have developed expertise in, developing sound risk management practices in connection with trading executed at the Exchange by an Exchange Floor Member to whom the FCM has provided a guarantee. As noted previously, the Exchange is suggesting that the Commission's order limit the scope of permissible trading to OTC transactions that are subsequently cleared at the Exchange. Thus, a Member Firm FCM could use its existing risk management practices and procedures for other futures contracts as applied to these futures contracts that also would be cleared at the Exchange.

Of course, FCMs would not be required to extend a guarantee to a local for OTC trading. Instead, the FCM could exercise its business judgment on a case-by-case basis in deciding whether to provide such a guarantee, presumably within the context of its existing relationship with the local. The additional OTC guarantee to the local thus represents a new business opportunity for the FCM community.

4. Sound risk management practices. By further facilitating use of EFS procedures to bring OTC positions onto the Exchange, the Commission would facilitate the ability of OTC market participants to limit their risk with respect to credit risk, market risk, and liquidity risk. By allowing NYMEX Floor Members to trade OTC swaps with a FCM guarantee, the Commission would enhance the ability of such Floor Members to manage the risks associated with the positions they establish in Exchange contracts while serving as liquidity providers at NYMEX.

5. Other public interest considerations. The proposed action is also consistent with several of the purposes for the Act articulated in Section 3 (Protection of the Public Interest). In particular, Section 3 provides that it is the purpose of the Act to "ensure the financial integrity of all transactions subject to this Act" (thus including transactions exempt from most CFTC oversight). In addition, Section 3 provides that it is the purpose of the Act to "promote responsible innovation and fair competition among boards of trade, other markets and market participants." As discussed above, the ability of Floor Members to trade OTC energy swaps with a FCM guarantee is a core component underlying the Exchange's business plans to innovate and to better serve the energy marketplace. Finally, the Exchange believes that the conditions discussed in a later section would establish appropriate safeguards for this proposed action.

III. Further Analysis of ECP Definition

A careful reading of Section 1a(12) of the Act reveals a number of arguments that support the proposed action. First, in this section, Congress expressly accepted the use of a guarantee by another entity as a substitute for a total assets approach to ensuring the financial integrity of transactions. Specifically, the Act permits a corporation, partnership, proprietorship, organization, trust or other entity to obtain a guarantee or support via a letter of credit from a financial institution, insurance company, investment company, commodity pool, or governmental entity.

Second, commodity pools generally are not in the business of conducting risk management for and providing guarantees in connection with trading in OTC markets. Yet Congress saw fit to allow a commodity pool with more than \$5 million in total assets to issue such guarantees. If Congress was willing to allow commodity pools to serve this function, it seems clear that FCMs, who are in the business of monitoring trading by the Exchange members that they

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guarantee, should similarly be permitted to provide such guarantees for Exchange Floor Members. In this connection, NYMEX rules currently provide that each Exchange Clearing Member registered as a FCM must maintain minimum working capital of at least \$5 million.

Third, Section 1a(12) would appear to create an inconsistency in regulatory treatment of floor traders and floor brokers depending on how they organize their businesses, but there does not appear to be a suitable regulatory purpose for this inconsistent treatment. Specifically, floor traders and floor brokers who operate as natural persons apparently must satisfy substantial total asset standards before being permitted to trade OTC products. On the other hand, if such floor traders and floor brokers have organized as partnerships or proprietorships, they could trade in OTC markets with a guarantee from one of the specified entities without needing to meet any total asset requirements.

As a threshold matter, 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.⁶

The Exchange does not oppose some financial standard for Floor Members to ensure their financial wherewithal, but also believes that it is questionable public policy to provide that only Floor Members 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.

Fourth, there is also a real inconsistency in Section 1a(12) regarding how brokers or dealers or foreign persons who are natural persons or proprietorships are treated relative to floor brokers and floor traders. Specifically, Section 1a(12) allows such persons or proprietorships to be considered to be ECPs either if they meet one of the total assets tests in clause (xi) or satisfy one of the provisions in clause (v). In other words, a broker or dealer or foreign person, even if operating as a natural person, may obtain a guarantee from a specified entity such as a commodity pool in lieu of satisfying a total assets test.

One possible basis for this flexibility is that the provision is limited to brokers and dealers subject to regulation under the Securities Exchange Act of 1934 and to foreign persons "performing a similar role or function subject as such to foreign regulation. . ." Thus, one possible rationale for the flexibility afforded to such persons is that they are already subject to a comprehensive regulatory scheme. However, like brokers and dealers, floor traders and floor brokers are subject to a comprehensive regulatory scheme as Commission registrants. If this type of flexibility is appropriate for foreign persons subject to a foreign regulatory scheme, it is surely also appropriate for Commission registrants subject to direct oversight by the CFTC itself.

IV. Further Analysis of ECE Definition

⁶ This industry practice may be subject to change in a demutualized environment.

Subsection (A) of the ECE definition, provides that certain ECPs referenced in that subsection qualify as ECEs if those ECPs meet one of several alternative conditions. One such condition would require that the ECP:

"is a dealer that regularly provides risk management or hedging services to, or engages in market-making activities with, the foregoing entities involving transactions to purchase or sell the commodity or derivative agreements, contracts, or transactions in the commodity."
(emphasis added.)

As noted previously, Exchange Floor Members are now acknowledged to provide risk management and market-making activities in energy and metals derivatives products. Allowing Floor Members with a FCM guarantee to trade as ECEs on electronic trading facilities limited to ECEs thus would simply be an extension of the services and expertise that Floor Members currently provide regularly to users of NYMEX's markets.

Another alternative would require that the ECP have a demonstrable ability to make or take delivery of the specified commodity. This condition is not relevant to the trading that would be done by Exchange Floor Members under the proposed relief because of the Exchange's suggested condition that such trading be limited to OTC contracts that would be subsequently cleared at the Exchange.

Consequently, a Floor Member's open position in a futures contract related to an OTC-cleared transaction generally would be in a futures contract involving cash settlement. For other contracts, such as the Exchange's Natural Gas contract, where EFS transactions are now permitted, a Floor Member's open position in such a contract nonetheless would be subject to Exchange rules, including NYMEX Rule 9.19 ("Final Day of Trading"). This rule requires a Clearing member who is not a position to fulfill its contractual obligation on any maturing contract to submit a liquidating order on the final day of that expiring contract month. Finally, as noted previously, the Exchange has also suggested that NYMEX Floor Members not be allowed to engage in OTC transactions in electricity commodities.

In conclusion, the core expertise of Exchange Clearing Members in serving collectively as professional market-makers in derivatives transactions in energy and metals commodities at the Exchange is entirely consistent with one of the specified alternatives for certain ECPs specified in this statutory definition to become an ECE, which requires that a dealer regularly provide such services. The other alternative means for a specified ECP to qualify as an ECE under subsection (A) are not relevant to the OTC trading that would be done by Exchange Floor Members in light of the restrictions and conditions that the Exchange has proposed as part of this petition. Thus, the Exchange believes strongly that it is indeed appropriate for the Commission to determine that Floor Members are ECEs pursuant to the limitations and exclusions suggested by the Exchange in this petition.

V. Trading Restrictions and Exchange Oversight

The Exchange represents that it will have appropriate compliance systems in place to monitor OTC trading by Exchange Floor Members. As noted previously, all of the permissible OTC trading allowable under the Exchange's proposed determination would subsequently be cleared at the Exchange. Accordingly, the Exchange would be able to obtain further details

regarding such OTC transactions as part of a review of the EFS transaction bringing the transaction to the Exchange for clearing. Failure to comply with such a request pursuant to the Exchange's EFS rules would result in a referral to the Exchange's Business Conduct Committee for further action.

In this regard, the Exchange notes that any transactions in exempt commodities executed pursuant to the provisions of Section 2(h)(1) (that are thus not executed on a "trading facility" as that term is defined) of the Act would be subject to the requirements of paragraph (2) of that Section 2(h); such transactions are thus subject to the Commission's anti-fraud and anti-manipulation prohibitions. The Exchange suggests that, consistent with the standards to which Exchange Floor Members are already in compliance with respect to their trading on the Exchange, the Commission's determination should provide that Floor Members' trading in the permissible contracts that is not executed on a trading facility be executed pursuant only to the Section 2(h)(1) exemption. Thus, all such transactions would be subject to the Commission's anti-fraud and anti-manipulation prohibitions.

Finally, Exchange staff has yet to identify a way in which Floor Members could use OTC trading to create harm to Exchange markets. Notwithstanding this review, as a prudential measure and as a condition for participating in OTC markets, the Exchange would agree to limiting OTC trading by floor traders and floor brokers to individuals and entities other than floor brokers and floor traders for contracts that are listed for trading on the Exchange, such as in connection with an OTC natural gas swap to be exchanged for a futures position in the Exchange's Natural Gas futures contract.

VI. New Circumstances as New Opportunity for Reconsideration by the Commission

In fairness to the Commission, it should be noted that the Commission has previously declined to extend this flexibility to Floor Members and brokers for trading in OTC markets. However, a review of the prior circumstances highlights the differences that now support a new review by the CFTC.

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 indicated in a footnote that it declined to adopt this proposal.⁷ Elsewhere in that release, the Commission indicated that it was using the total asset requirement as an indication of financial sophistication.⁸

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. Instead, the rule essentially treated Floor Members organized as natural persons in the same manner as other natural persons and made no

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

⁸ Id.

recognition of their status as Commission registrants or their expertise in providing liquidity for derivatives products.

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 in the context of Section 1a(12). Moreover, the many changes in OTC markets in the decade since that time also warrant revisiting this issue. Finally, the Commission now has broad and express statutory authority in this area.

More recently, when the CFTC issued final rules for trading facilities last year, the Commission elected to go beyond the statutory definition of an eligible commercial entity for purposes of Part 37 (for trading on a DTF) to include a registered floor trader or floor broker trading for its own account whose trading obligations are guaranteed by a registered futures commission merchant. However, the Commission did not expand upon the statutory definition of ECPs for purposes of trading on exempt markets under proposed Part 36. As a note, that rule package also did not include any amendments to the CFTC's Part 35.

Based upon a footnote in a set of final rules promulgated in November 2000 that were subsequently withdrawn because of the passage of the CFMA, it appears that the Commission's willingness to expand the scope of eligibility for trading on a DTF may have been based in part "on the important role that floor brokers and floor traders, which are Commission registrants, may fulfill in trading on a Commission-recognized market under the part 37 exemption." The Commission then suggested in the footnote that the same reasoning did not apply in the context of Part 35 or the Part 36 exemption [for exempt markets].

However, as detailed in a previous section in this document, the impact on the role of the local as a liquidity provider for Exchange contracts is but one of a number of solid policy rationales supporting allowing Floor Members to trade OTC products with a FCM guarantee. Moreover, in the last year or so, the ongoing, long-term process of OTC and exchange markets blending their businesses together has accelerated dramatically. Thus, a fresh review by the Commission of this issue is both timely and appropriate.

VII. Conclusion

In conclusion, the Exchange, acting on behalf of Floor Members requests that the Commission make a determination pursuant both to Section 1(a)(11)(C) and to Section 1a(12)(C) that Floor Members, when acting in a proprietary capacity, may enter into certain, specified OTC transactions in exempt commodities if such Commission registrants have obtained a financial guarantee for such trades from an Exchange Clearing Member who is registered with the Commission as a FCM.

With respect to the OTC transactions that would be permissible under the determination petitioned by the Exchange, NYMEX suggests that such OTC transactions be limited to trading to in a commodity that either:

- (1) is listed only for clearing at the Exchange; or
- (2) is listed for trading and clearing at the Exchange and where Exchange rules provide for exchanges of futures for swaps in that contract.

Such trading could be undertaken either in the traditional bilateral OTC market or in an electronic trading facility where ECPs or ECEs (such an electronic trading facility exempted pursuant to Section 2(h)(3) of the Act) were eligible to trade on the system. Notwithstanding the above, the Exchange further suggests that the scope of permissible transactions in exempt commodities not include at this time any transactions in electricity commodities. Finally, such transactions also would be subject to the additional conditions and restrictions detailed in this filing.



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Mercantile Exchange

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June 3, 2002

SUBMITTED VIA E-MAIL AND FACSIMILE

David P. Van Wagner, Esq.
Division of Trading and Markets
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Supplement to NYMEX Petition

Dear Mr. Van Wagner:

In the Exchange's petition submitted by letter dated May 23, 2002, the Exchange sought a determination from the Commission with regard to two statutory categories of eligible participants: eligible contract participants ("ECP") and eligible commercial entities ("ECE"). In that petition, the Exchange also stated that as a prudential measure and as a condition for participating in OTC markets, the Exchange would agree to limiting OTC trading by floor traders and floor brokers to individuals and entities other than floor brokers and floor traders.

The purpose of this letter is to clarify that this restriction would apply only to OTC trading by Floor Members acting as ECPs. The Exchange does not intend for this limitation to apply to Floor Members acting as ECES and trading on exempt electronic trading facilities. Such facilities may well permit transactions to be conducted anonymously between counterparties, and thus the Exchange would have no effective means of ensuring compliance with this restriction for trading on such facilities.

Should you have any questions concerning the above, please contact the undersigned at 212-299-2207.

Very truly yours,

Brian J. Regan
Senior Associate General Counsel

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New York, NY 10282-1101
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June 3, 2002

Ms. Jean Webb,
Secretary,
Commodity Futures Trading Commission,
1155 21st Street, N.W.,
Washington, D.C. 20581.

Re: Petition for Commission Order Pursuant to Section 1a(11) of the
Commodity Exchange Act

Dear Ms. Webb:

On behalf of the Intercontinental Exchange Inc. (Intercontinental Exchange), we respectfully request that the Commission expand the category of eligible commercial entity (ECE) under the Commodity Exchange Act (CEA) to include floor brokers and floor traders registered in the U.S. or with the U.K. Financial Services Authority (FSA) trading on an exempt commercial market (ECM). Intercontinental Exchange operates an OTC commodities trading platform for energy and metals. By letter dated December 27, 2001, as amended by letter dated March 19, 2002, Intercontinental Exchange has notified the CFTC of its operation as an ECM. Separately, Intercontinental Exchange in 2002 notified the Commission that it intended to clear OTC energy and metals products through an arrangement with the London Clearing House. Intercontinental Exchange also owns the International Petroleum Exchange (IPE), a U.K. FSA regulated futures exchange for the trading of energy futures products.

The Commission has the authority to expand the ECE definition. Pursuant to Section 1a(11) – the term “eligible commercial entity” means, with respect to an agreement, contract or transaction in a commodity –

- (C) such other person as the Commission shall determine is appropriate and shall designate by rule, regulation or order.

The Commission has issued such an order with respect to Derivative Transaction Execution Facilities (DTEF). 17 C.F.R. Section 37.1 provides:

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- (b) Definition. As used in this part, the term "eligible commercial entity" means, and shall include, in addition to a party or entity so defined in Section 1a(11) of the Act, a registered floor trader or floor broker trading for its own account, whose trading obligations are guaranteed by a registered futures commission merchant.

We submit there is no meaningful distinction between allowing floor brokers and floor traders to trade as ECEs on a DTEF compared to trading as ECEs on an ECM. The Commodity Futures Modernization Act (CFMA) generally defines three categories of ECE:

- (i) Commercials who deal in the underlying physical commodity;
- (ii) Dealers and market makers; and
- (iii) Collective investment vehicles that generally are liquidity providers.

Categories (ii) and (iii) recognize that traders with no direct connection to the underlying physical market are eligible and valuable contributors to the efficiency of commercial markets. Including floor brokers and floor traders as ECEs is consistent with the CFMA and would recognize the value of floor brokers and floor traders as both liquidity providers and dealers and market makers. Floor brokers and floor traders understand trading markets and are as sophisticated and capable traders as any commercials. Certainly, the Commission reached this conclusion with respect to floor brokers and floor traders trading on DTEFs.

In addition to U.S. registered floor brokers and floor traders, local member floor traders who are authorized persons under the Financial Services and Markets Act of 2000 (FSMA) should be included in the definition of ECE. Local members, because they transact business as a principal on the floor of an exchange either on their own behalf or on behalf of other floor or local members, carry on the regulated activity of dealing as principal (Article 14 of FSMA (Regulated Activities) Order 2001 (RAO)) and must be an authorized person under FSMA.

Local members can be individuals or corporations. To become authorized persons, they must meet fitness and proper standards, put in place proper internal systems and controls, have competent and prudent management and conduct their affairs with due skill, care and diligence. An authorized person is subject to FSA rules including capital and conduct of business requirements. The IPE monitors the activities of local members and has the authority to sanction them in the event of their improper conduct. In addition, the IPE will cooperate with the Intercontinental Exchange and with any other exchange on which its local members may trade or on which its products or similar products may be traded. Such cooperation will include intermarket surveillance.

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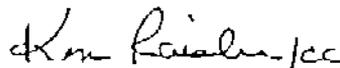
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We would suggest the following criteria for eligible floor brokers and floor traders on an ECM. We would suggest that a definition of ECE for ECMs include:

- (i) U.S. registered floor brokers or floor traders or a U.K. authorized local member floor trader (the floor broker or floor trader is not required to have any connection or experience trading in the underlying commodity);
- (ii) the floor broker or floor trader must be a member of a designated contract market (DCM) or a U.K. futures exchange or otherwise have trading privileges on a DCM or a U.K. futures exchange;
- (iii) the floor broker or floor trader must have as a part of its business the business of acting as a floor broker or floor trader; and
- (iv) the floor broker or floor trader is an eligible contract participant (ECP) or, if the floor broker or floor trader is not an ECP, its trades must be guaranteed by a clearing member of a U.S. or U.K. recognized clearing organization.

We look forward to the opportunity to discuss this proposal with you. We are anxious to move forward on this important initiative and are prepared to assist the Commission in whatever way possible to move this ahead.

Sincerely,



Kenneth M. Raisler

cc: David Goone
James Falvey
(IntercontinentalExchange)