



New York Mercantile Exchange

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VIA FACSIMILE

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

COMMENT

Re: CFTC Request for Public Comment on ECE Petition

Dear Ms. Webb:

The New York Mercantile Exchange, Inc. ("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"), to the Commodity Futures Trading Commission ("CFTC" or "Commission") on the petition ("Petition") that was submitted by letter dated February 9, 2004, by the Intercontinental Exchange, Inc. ("Intercontinental"). NYMEX is a for-profit corporation organized under the laws of the state of Delaware. It is a designated contract market and regulated derivatives clearing organization for the trading and clearing of numerous commodity futures and commodity futures options and other products. NYMEX is the largest exchange in the world for the trading of futures and option contracts based on physical commodities. Participants in our markets include institutional and commercial producers, processors, marketers and users of energy and metals products.

Based upon the summary provided in the Federal Register release, Intercontinental has requested that the CFTC expand the statutory category under the Commodity Exchange Act ("Act") of "eligible commercial entity" ("ECE") that would be eligible to trade only on the exempt commercial market ("ECM") operated by Intercontinental. In other words, this regulatory relief would be limited only to Intercontinental's own ECM and would not apply to any other market that has notified the CFTC that it is operating pursuant to the exemption from most CFTC regulation provided by Section 2(h)(3)-(5) of the Act.

Specifically, Intercontinental is proposing that the Commission include, in this ECE category, electronic and floor broker firms based in the United Kingdom that are members of the International Petroleum Exchange ("IPE") and also include individuals trading for their own accounts in IPE markets, including not only "local" IPE floor traders but also including even individuals who have simply been granted electronic trading privileges by the IPE to trade IPE futures and option contracts solely on an electronic trading platform.

I. Overview

In support of its Petition, Intercontinental apparently is attempting to assert that such a broad and largely unrestricted expansion of the limited ECE category for the specialized "commercials-only" type of market established by Congress in the Commodity Futures Modernization Act of 2000 ("CFMA") is consistent with the Act. In addition, Intercontinental is attempting to assert that this sweeping expansion of the category of eligible participants would be (in its view and as characterized in the release) a "logical and appropriate"

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

extension of regulatory relief on the ECE category that was issued by the CFTC early last year. This CFTC order ("ECE Order") was published in the Federal Register on January 16, 2003 and became effective on that same day. 68 Federal Register 2319 (January 16, 2003).

As further detailed below, we strongly disagree with both of Intercontinental's contentions. The scope of this proposed broad expansion in permissible ECE participants now being pursued by Intercontinental (but only for its own ECM) is flatly inconsistent with the legislative design and intent both for exempt commercial markets and for the eligible participants for such markets. This new request by Intercontinental also ignores much of the underpinning of the carefully crafted regulatory relief provided by the CFTC last year in the ECE Order.

In addition, Intercontinental is in essence proposing to open up its ECM to a potentially large group of relatively unschooled and unsophisticated electronic traders who are not required to be registered here or in the U.K. with any governmental body and who will not be subject to any self-regulatory oversight either by the IPE or by Intercontinental for their trading on this ECM. We believe that such a potentially rash action may have a number of unintended consequences, including possible risks to the market integrity of Intercontinental's markets and to other markets and to the adequacy of customer protection safeguards for these traders while trading on Intercontinental. In sum, the expansive regulatory relief now being sought by Intercontinental would contrast sharply with the legislative intent of the statute creating the Section 2(h) markets, would be extremely ill-advised as a matter of public policy and therefore would be clearly contrary to the public interest. Finally, we would respectfully suggest that the Commission should clarify in any order granted to Intercontinental the nature and scope of the additional limiting restriction regarding trading for one's own account.

II. Commodity Exchange Act and Prior CFTC Regulatory Relief

A. Statutory Review

Under the CFMA, Congress chose to tailor the level of regulation applicable to derivatives transactions based on a handful of key concerns, including the type of underlying commodity, the level of sophistication and financial wherewithal of the market participants, and the type of forum where the transaction occurred. Thus, for example, an individually negotiated transaction in a derivative based upon a financial index that was executed on a principal-to-principal basis between two sophisticated counterparties would be appropriately excluded under one or more statutory exclusions under the Act from nearly all CFTC regulation and oversight. On the other hand, a much more substantial level of regulation would apply and would clearly be appropriate for a transaction occurring on an organized electronic trading facility that matches bids and offers from a diverse number of buyers and sellers and where the market allows for participation by far less sophisticated participants and further allows other persons or firms to execute orders on behalf of such customers.

More specifically, Congress established two new statutory categories under the CFMA to identify companies and individuals who would be eligible to participate in transactions that would be excluded and/or exempt from most CFTC regulation. In the category of "eligible contract participant," Congress included a number of entities that ostensibly were included in the category because the nature of their line of business or activity, their financial wherewithal or their level of regulation supported their inclusion in this category of sophisticated traders. The ECP definition includes CFTC-registered floor traders and floor brokers and individuals who can demonstrate significant net worth on the basis of a total assets test. By contrast, the ECE category is far more restrictive. The ECE category specifically omits a number of the subcategories of entities or persons that qualify as sophisticated traders under the ECP definition.

As indicated by its name, Congress established the exempt commercial market category as a special commercials-only market. As noted by Intercontinental's outside counsel in a recent comment letter to the CFTC submitted on behalf of Intercontinental, the exempt commercial market category

"is framed as a broad exemptive provision that places ECMs outside the regulatory scheme. In amending the CEA . . . , Congress clearly intended that, as the name suggests, such entities be

3

exempt from Commission regulation, rather than simply being subjected to a "lighter" system of regulation."¹

What is the public policy basis for such a broad general exemption from Commission regulation? It is abundantly clear that this Congressional determination is grounded in large part upon clear and substantial restrictions on the scope of participants eligible to trade on that system.

As to the statutory definition for ECEs, even within the ECP subcategories that are not omitted by the ECE definition, the definition then imposes several alternative tests that must be satisfied to qualify as an ECE. Thus, the ECE category is further limited to participants that, in connection with their businesses, demonstrate the ability to make or take delivery of the underlying commodity, incur risk in addition to price risk related to the commodity or are a dealer that regularly provides risk management or hedging services or engage in market-making activities with respect to the commodity or derivatives transactions in the commodity. There is a further alternative test for certain specified collective investment vehicles that requires that such a vehicle regularly enter into transactions to purchase or sell the commodity or derivative transactions in the commodity. As noted by the Commission in the release accompanying the ECE Order, for those entities that cannot demonstrate the ability to make or take delivery, the ECE category requires "by statute, a strong connection to either derivatives transactions in the commodity or the underlying physical market."²

In sharp contrast to the Congressional design for the ECM structure and to the clear legislative intent, Intercontinental now proposes in essence to open up access to its ECM to anyone who manages to obtain electronic trading privileges from the IPE. What is necessary to obtain such privileges from the IPE? Based upon our conversations with IPE membership department staff, it appears that there are only a few limited conditions to be satisfied before an individual could obtain such an electronic trading privilege. Aside from turning in a short application and executing the requisite IPE "platform user agreement" and aside from establishing an account with a London Clearing House clearing member, the only other apparent requirement is a fairly modest background check. There is no explicit condition relating to training or experience (the IPE online training tutorial is entirely optional), there is no requirement of any sort relating to financial net worth, and finally there is also no ongoing requirement or condition to be met concerning a minimum level of trading volume on the system, i.e., regular trading on the system.³

We are highlighting this short list of conditions to become an IPE electronic trader for the limited purpose of emphasizing to the Commission a fundamental truth regarding Intercontinental's current proposal. Specifically, if Intercontinental were to convince the CFTC to allow it to make its ECM (but only its own ECM) accessible on such an unrestricted basis to such a potentially large pool of individual electronic traders, Intercontinental would in effect be converting that exempt commercial market into a market that would not only allow but indeed would even seemingly encourage participation by individuals who are most fairly characterized as "retail" traders.

We find it deeply troubling and rather unfortunate that Intercontinental would first notify the CFTC that it is operating a commercials-only market pursuant to the statutory exemption provided by Section 2(h)(3) of the Act, which is clearly grounded in large part by the exclusion of retail participants and which has little to no protection for retail customers, and then wait a year or two and return to the CFTC to request in effect that its exempt commercial market now be made accessible to, well, retail participants. Intercontinental may somehow believe that it is entitled to have it both ways but it has yet to reconcile the internal contradictions of its proposed method of business operation, and we seriously doubt that this can be

1 Sullivan and Cromwell comment letter to CFTC dated January 26, 2004, submitted on behalf of Intercontinental, page 1. This comment letter responded to the request for public comment included in the CFTC's release published at 68 Federal Register 66032 (November 25, 2003).

2 68 Federal Register 2319, n.16 at 2322 (January 16, 2003)

3 NYMEX is not calling into question the adequacy of these conditions as applied to trading on the IPE and instead we presume that such conditions are adequate and appropriate for the IPE's own purposes. We are merely questioning their appropriateness as applied to a "commercials-only" market.

justified in any way as consistent with the CFMA and with Congressional intent.

B. Prior CFTC Regulatory Relief

Under the ECE Order, the CFTC expanded the ECE category to include, subject to certain conditions, CFTC-registered floor brokers and floor traders when trading for their own proprietary accounts. (The ECE Order by its terms allows these ECEs to trade on any ECM meeting the requirements of Section 2(h)(3)-(5) of the Act.) NYMEX supported this Commission action as a judicious use of its authority under Section 1a(11)(C) of the Act, which authorizes "appropriate" expansion of the ECE category. Taking the order and the related Federal Register release reviewing the public comments as a whole, it is our understanding that this Commission action was grounded, among other things, upon the following various conditions and related insights:

- a) relief would be limited to CFTC-registered floor brokers and floor traders;
- b) such traders function in a professional capacity as liquidity providers;
- c) such traders have specialized expertise in trading derivatives products generally;
- d) such traders regularly trade on derivatives markets in this capacity; and
- e) such traders either are members of a designated contract market or otherwise have trading privileges on a designated contract market that is fully regulated by the CFTC.

On the other hand, Intercontinental by its own admission acknowledges in the Petition that IPE local traders are "outside the scope of FSA regulation." As Intercontinental made clear in its Petition, this non-regulated status applies both to IPE floor traders and to persons who are only admitted to participate in electronic trading of IPE products ("Individual Participants"). In addition, because there are no express requirements at the IPE regarding training, experience, financial wherewithal or regular participation for electronic traders and no indication from Intercontinental that it would impose any additional conditions in these areas, there is a serious question as to the extent to which such individual traders would serve in the role of liquidity providers for Intercontinental's ECM. Consequently, we find Intercontinental's assertion (that allowing such traders to participate in its ECM would be a "logical extension" of the Commission's prior regulatory relief expanding the ECE category) to be fanciful at best.

III. Public Policy Concerns

As noted previously, Intercontinental in effect is proposing to turn its ECM in large part into a retail market. Yet it could not be clearer that ECMs generally and Intercontinental specifically are not structured to provide adequate customer protections for such retail customers. In the absence of such protections, allowing small, thinly capitalized and relatively unschooled retail traders to participate in the same market as sophisticated and savvy entities is inconsistent with one of the purposes for the Act as set forth in Section 3(b) of the Act regarding protection of market participants and of customer assets.

In addition, we could not help noticing that while touting the various components of the IPE's regulatory regime for trading on the IPE, Intercontinental also wasted no time in making clear that the IPE would undertake no oversight or any other self-regulatory ("SRO") responsibilities in connection with any of the trading on the ECM of any IPE member or member firm or any other person who had been granted electronic trading privileges by the IPE. Moreover, the Act is generally understood to impose no clear SRO duties on ECMs and, as best as we can determine, Intercontinental has not undertaken any steps to assume on a voluntary basis any SRO obligations or responsibilities. Thus, there is at present no effective SRO oversight of Intercontinental's ECM market, and this would remain the case in the event that the Commission granted the requested relief to Intercontinental.

The net effect would be that a potentially large number of individuals could be set loose on this market and these individuals would not be subject to registration by any governmental body and further would not be subject to any manner of SRO regulation for trading on this ECM market.⁴ This would leave the CFTC

⁴ While Intercontinental proposes that (at least upon the initial issuance of any regulatory relief) such local

5

itself as the last and only line of defense against any objectionable trading by these unregulated traders. In our view, opening up such a Pandora's box at this time would be greatly at odds with the CFTC's ongoing and aggressive efforts to enforce applicable requirements in OTC energy markets. Finally, given that Intercontinental's ECM for some time now has listed products for trading that are look-alikes of products listed on other markets and indeed are settled upon the products of other markets, allowing Intercontinental to convert its ECM into a retail market possibly could have the unintended and ironic consequence of permitting problems to fester on the Intercontinental market that may well have spillover effects on other markets, including markets that clearly allow for and protect their retail customers. These markets thus would need to bear the brunt of problems created by Intercontinental even while they could have done nothing to prevent these harms being inflicted on their markets.

IV. Restriction to Trading for Own Account

A core condition for participation on an ECM is that trading be limited to "principal-to-principal" trading between persons or firms that are ECEs as of the time of the trade. By comparison, consistent with the scope of the relief contained in the CFTC's ECE Order for CFTC-registered floor brokers and floor traders, Intercontinental's Petition proposes that the two distinct groups of persons to be included in the ECE definition have their activity be further limited to "trading for their own account." At present, these phrases are defined neither by the Commodity Exchange Act nor by Commission regulation or interpretation. Consequently, there may be some uncertainty regarding the exact parameters of the activity permitted pursuant to these requirements.

This uncertainty may be heightened for IPE members and member firms, such as for the broad swath of IPE firms who specialize in brokerage business for their customers. These firms, which would be included in the relief requested by Intercontinental, are likely far less familiar with the nuances of U.S. regulatory culture than is the case with U.S.-based floor traders and brokers who are subject to the CFTC's jurisdiction. Consequently, we would respectfully suggest that, in the event the CFTC determines to issue any regulatory relief to Intercontinental on its Petition, the order should make clear the scope and nature of the additional limiting restriction that persons and firms acting pursuant to such an order be limited to "trading for their own account."

V. Conclusion

The scope of this proposed broad expansion in permissible ECE participants now being pursued by Intercontinental (but only for its own ECM) is flatly inconsistent with the legislative design and intent both for exempt commercial markets and for the eligible participants for such markets. This new request by Intercontinental also ignores much of the underpinning of the carefully crafted regulatory relief provided by the CFTC last year in the ECE Order.

In addition, Intercontinental is in essence proposing to open up its ECM to a potentially large group of relatively unschooled and unsophisticated electronic traders who are not required to be registered here or in the U.K. with any governmental body and who will not be subject to any self-regulatory oversight either by the IPE or by Intercontinental for their trading on this ECM. We believe that such a potentially rash action may have a number of unintended consequences, including possible risks to the integrity of Intercontinental's markets and to other markets and to the adequacy of customer protection safeguards for these traders while trading on Intercontinental.

In sum, the expansive regulatory relief now being sought by Intercontinental would contrast sharply with the legislative intent of the statute creating the Section 2(h) markets, would be extremely ill-advised as a matter of public policy and finally therefore would be clearly contrary to the public interest. In addition, we

traders would need to be based in the UK, the value and viability of this apparent restriction are seemingly called into question by Intercontinental's repeated emphasis that commodity trading markets are now "global" in scope. Moreover, the Petition does not indicate how this geographical restriction on these electronic traders would be maintained. In light of Intercontinental's ongoing unwillingness to undertake any SRO duties on its own, it is not clear whether (and if so how) Intercontinental intends to monitor its self-imposed restriction.

6

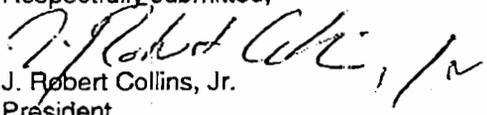
would respectfully suggest that the Commission should clarify in any order granted to Intercontinental the nature and scope of the additional limiting restriction regarding trading for one's own account.

Finally, the Commission also sought comment with respect to whether any Commission response to the Petition should be tailored specifically to allow IPE members meeting the conditions presented by the Petition to trade on Intercontinental, or whether a response should be more broadly based and, thus, allow such IPE members to trade on other ECMs. Noting the serious concerns that we have set forth elsewhere in this comment letter regarding granting the relief now being requested by Intercontinental, let us *assume arguendo* that the Commission determines to fashion some type of response to the petition.

In this instance, we have been unable to identify from the Petition or from the CFTC's release any factual circumstances that would be unique to Intercontinental's ECM. Thus, for example, it does not appear that Intercontinental has indicated a willingness to assume any affirmative obligations in connection with the proposed grant of relief. In other words, there is an absence of any need to tailor any hypothetical relief to the specific factual circumstances of Intercontinental's market. We also question the appropriateness of creating private definitions for public statutory categories. Accordingly, despite our general view that granting the relief requested by Intercontinental would be ill-advised, we suggest that the Commission may wish to consider allowing such IPE members to trade on other ECMs.

NYMEX thanks the Commission for the opportunity to submit comments concerning the Intercontinental's ECE Petition 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,


J. Robert Collins, Jr.
President

cc: Chairman James E. Newsome
Commissioner Sharon Brown-Hruska
Commissioner Walter Lukken