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October 12, 1998

T. Eric Kilcollin  
President and Chief Executive Officer  
312/930-4570  
FAX: 312/648-3625  
rkilcoll@cme.com

Ms. Jean A. Webb  
Office of the Secretariat  
Commodity Futures Trading Commission  
1155 21st Street, N.W.  
Washington, D.C. 20581

COMMODITY FUTURES  
TRADING COMMISSION  
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COMMENT

Dear Ms. Webb:

On May 6, 1998, the Commission published a Concept Release respecting regulation of the OTC derivative markets. It invited discussion of the broad range of issues described in the release and sought responses to 75 specific questions. The Chicago Mercantile Exchange ("CME" or "Exchange") hereby responds to the important philosophical issues raised by the Release.

The over-the-counter ("OTC") derivative market has mushroomed in size and scope since the Commodity Futures Trading Commission's swap policy statement was promulgated on July 21, 1989. In 1989 the outstanding notional value of interest rate and currency swaps was estimated at less than \$2 trillion. The Commission's adoption of the swap exemption ("Part 35") in January, 1993, reconfirmed its policy statement. At that time the swap market had grown to approximately \$10 trillion. At the end of 1996, the reported notional value of outstanding interest rate and currency swaps and currency options was \$25.4 trillion. ISDA reports growth in that segment of 13% to \$28.733 trillion by the second quarter of 1997. Recent reports put the growth during 1997 at 25%. This implies a size of approximately \$35 trillion at the beginning of 1998. During this period of rapid market change and growth, the types of contracts traded, the customers participating and the means by which trading is conducted have all changed.

At the time the Commission crafted its swap exemption, swap contracts were individually negotiated in face-to-face transactions between end users and banks or dealers. A substantial segment of the market now consists of standardized contracts, known as plain vanilla swaps, traded by means of electronic systems or formally organized broker markets. Those contracts are indistinguishable from standardized futures contracts and the trading systems are beginning to look exactly like organized exchanges. The instruments are futures contract equivalents; the trading is done through exchange-like facilities. Netting and novation agreements create fungibility and serve as effective substitutes for mutualized clearing.

30 South Wacker Drive Chicago, Illinois 60606 312/930-1000

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Ms. Jean A. Webb  
October 12, 1998  
Page 2

It is an understandable response to radically altered conditions that the Commission reevaluates the terms of its regulations. The OTC derivatives business has been conducted pursuant to CFTC exemptions. Most of the instruments traded in the OTC market are clearly "contracts of sale of a commodity for future delivery" governed by the Commodity Exchange Act. The CFTC is the agency most familiar with derivative trading issues. The Commodity Exchange Act grants exclusive jurisdiction over most swaps to the Commission, and the Commission has a right and an obligation to periodically review the exemptions it has granted from the Act.

Nonetheless, the CME is concerned by the manner in which the questions have been shaped and by their failure to address directly whether any federal regulation of financial derivative transactions among sophisticated investors, OTC or exchange traded, is necessary or useful. The CME believes that the baseline for Commission inquiries should be establishing the least intrusive regulation for all members of the derivative community consistent with the CEA and sound public policy.

The CME's support of the Commission's jurisdiction to issue the Concept Release does not imply unqualified support of changes in the scope of the swap exemption. Obviously, the OTC market has grown rapidly despite well-publicized losses. It must be providing a service that its customers value. CME believes that recent extreme losses and dislocations involving off-exchange derivatives must be assessed before formulating additional regulation.

However, even without such analysis, CME is certain that a strong case can be made against unilaterally weakening those provisions of Part 35 that preclude the OTC market from retaining the advantages of its unregulated status while replicating the functions and features of exchange traded futures contracts. In particular, the CME opposes any effort to eliminate those provisions of Part 35 that limit the exemption to non-standardized, privately negotiated transactions that are not executed by means of an electronic trading system or settled through a clearinghouse if such trading or clearing system is not subject to appropriate CFTC regulation. If and when the Commission chooses to eliminate such constraints it should provide a balanced solution that will offer equivalent relief to exchange traded financial products and clearinghouses operated by designated contract markets.

It is discomfoting that the Commission appears to be moving toward even more regulatory relief for the OTC market -- the healthiest and fastest growing segment of the industry -- and ignoring designated contract markets. Additional relief for the OTC market without first curing the existing unjustified disparities created by the original exemptions is inconsistent with the Act, clearly expressed congressional intent, and basic fairness. The CME is concerned that the competitive disadvantage under which it struggles will increase if relief for OTC markets is not coupled with equal treatment for exchange based transactions. The CME

Ms. Jean A. Webb  
October 12, 1998  
Page 3

urges the Commission to withdraw the Concept Release in favor of a unified effort to reform regulatory policy for all segments of financial derivative markets.

Sincerely,

A handwritten signature in black ink, appearing to read "T. Eric Kilcollin".

T. Eric Kilcollin  
President and Chief Executive Officer