

# CHICAGO MERCANTILE EXCHANGE

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VIA FACSIMILE AND MAIL

April 30, 1999

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

**COMMENT**

RE: Access to Automated Boards of Trade

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Dear Ms. Webb:

Last year, the Commission issued a "Concept Release" on issues relating to access to automated trading systems of foreign exchanges. After reviewing the comments received on the Concept Release, the Commission published proposed rules regarding access to automated boards of trade in 64 *Federal Register* 14159 (March 24, 1999) (the "Release") and invited public comments on the proposed rules. The Chicago Mercantile Exchange ("CME") is pleased to offer these comments.

## Principles Underlying CME's Position

The CME believes in free trade and fair competition. We invite foreign exchanges to come into the U.S. through electronic access to U.S. persons, whether via a direct execution system ("DES") or an automated order routing system ("AORS"). However, in that event, the CME believes that U.S. exchanges must achieve regulatory parity with the foreign exchanges so that the competition between them is fair.

Consistent with these principles, the CME supports the following approach. Whenever a foreign exchange is granted electronic access to persons in the U.S., whether via a DES or an AORS, U.S. exchanges are entitled to regulatory parity with such exchange through the following means:

- (1) Either the CFTC shall grant an exemption allowing U.S. exchanges to engage in any of the practices that are allowed for the foreign exchange; or
- (2) The CFTC shall prohibit the foreign exchange from engaging in practices, with respect to U.S. persons having electronic access to its market, that are not allowed for U.S. exchanges.

In order to uphold the foregoing principles, we believe that the CFTC should adopt rules concerning electronic access by U.S. persons to automated trading systems of foreign exchanges.

### **Comments on Proposed Rule 30.11**

The proposed rules make it unlawful for a U.S. person to use either a DES or an AORS to enter orders to an automated matching system of a foreign exchange unless the foreign exchange is:

- A designated contract market approved by the CFTC;
- A "linked exchange" where the CFTC has approved rules submitted by a U.S. exchange that allows the products of the foreign exchange to be offered and sold in the U.S.; or
- Exempted by submitting a petition for the CFTC's approval under proposed Rule 30.11.

The CME supports these provisions. With respect to a linkage arrangement between a U.S. exchange and a foreign exchange, we note that the Commission approved the CME-MATIF cross-exchange trading arrangement through GLOBEX® terminals after an intensive review of the MATIF trading rules, the applicable French regulatory requirements, and how such requirements would be enforced. Given the nature and scope of such review, it would serve no purpose for MATIF to submit the same information again to the CFTC in connection with a Rule 30.11 exemption petition.

Proposed Rule 30.11 provides a framework by which U.S. persons can obtain electronic access to the automated trading system of a foreign exchange without the foreign exchange being designated as a U.S. contract market or being linked to a U.S. exchange. The proposed rule provides that a foreign exchange may petition the CFTC for an exemption pursuant to Section 4(c) of the Commodity Exchange Act ("Act") that would enable such exchange's products to be accessed from a DES or an AORS located in the U.S. without requiring the foreign exchange to be designated as a U.S. contract market. The petition must contain certain specified information, including the exchange's rules, the laws and regulations in effect in its home country, the exchange's automated trading system, and the extent of such exchange's activities and presence in the U.S. Notice of such petitions would be published in the *Federal Register*, and interested parties would have an opportunity to request information concerning the petition.

The proposed rule also sets forth standards for the issuance of exemptive orders to a foreign exchange. The CFTC would grant an exemption to a foreign exchange if it finds that:

1. The foreign exchange is an established exchange primarily located in a foreign jurisdiction;
2. The foreign exchange is subject to a regulatory structure "generally comparable" to that in the U.S. with respect to the protection of customers and market integrity;
3. The foreign exchange is present in the U.S. (except for incidental contacts) only by virtue of being accessible from within the U.S. via an automated trading system;
4. The foreign exchange is willing to submit to the jurisdiction of the CFTC and U.S. courts in connection with its activities under the exemptive order;
5. The foreign exchange has its automated trading system approved by its home regulator in accordance with IOSCO's principles on screen-based trading or substantially similar standards; and
6. Satisfactory information-sharing arrangements are in effect between the CFTC and the foreign exchange and its regulatory authority.

The CME believes that the first three standards listed above are the most significant, and we will comment on each of them.

The first standard is that the foreign exchange is an established exchange primarily located in a foreign jurisdiction. The CME strongly supports this standard. As noted in the CFTC's Concept Release, the legislative history concerning Section 4(b) of the Act makes it clear that the foreign futures contracts that may be offered or sold in the U.S. must be bona fide foreign futures contracts traded in a regulated exchange environment. Nothing in the CFTC's proposed approach would permit the offer and sale in the U.S. of foreign futures that are not executed on or subject to the rules of a foreign exchange. Accordingly, an entity such as the EBS Partnership, which is not regulated as an exchange in any jurisdiction, would not be allowed to offer or sell standardized forward rate agreements in the U.S. that constitute contracts of sale of a commodity for future delivery within the meaning of the Act.

The second standard provides that the foreign exchange must be subject to a regulatory structure generally comparable to that in the U.S. As explained in the CFTC's Release, the foreign regulatory regime should be generally comparable to that in the U.S. in providing for (a) prohibition of fraud, abuse and market manipulation relating to trading on the foreign exchange's market; (b) recordkeeping and reporting by the foreign exchange and its members; (c) fitness standards for intermediaries operating on the foreign exchange's markets; (d) financial standards for the foreign exchange's members; (e) protection of customer funds, including procedures in the event of a clearing member's default or insolvency; (f) trade practice standards; (g) rule

review or general review of the foreign exchange's operations by its regulatory authority; (h) surveillance, compliance and enforcement mechanisms; and (i) regulatory oversight of clearing facilities.

The CME generally believes that there is too much government regulation over exchange markets, particularly in the U.S. Accordingly, the CME does not believe that government regulation is needed in all of the areas specified above. The CME also believes in fair competition -- a level playing field so that U.S. exchanges can compete fairly with foreign exchanges. Therefore, to the extent that an electronic trading system operated by a U.S. exchange must meet certain requirements imposed by the Act or by the CFTC as being necessary for customer protection, the electronic trading systems of foreign exchanges where there is electronic access from the U.S. should be subject to the same requirements. Put differently, to the extent that a foreign exchange where there is electronic access from the U.S. is allowed to use trading practices that the CFTC does not allow U.S. exchanges to use, the CFTC should immediately grant an exemption to the U.S. exchanges so that they are free to use the same practices.

In order to implement a level playing field, the CME recommends that the following procedure be followed. A foreign exchange seeking electronic access to persons in the U.S. should file a petition for exemption with the CFTC that specifies the rules and practices applicable to persons participating in its market. Notice of such petition should be published in the *Federal Register*, and U.S. exchanges should be given an opportunity to notify the CFTC of those rules and practices of the foreign exchange that are prohibited for U.S. exchanges under the Act or CFTC regulations. For each rule or practice so identified, the CFTC should either (1) grant an exemption pursuant to Section 4(c) of the Act allowing U.S. exchanges to engage in such practice or (2) prohibit the foreign exchange from engaging in such practice with respect to U.S. persons having electronic access to its market.

The third standard provides that the foreign exchange can be present in the U.S. (except for incidental contacts) only by virtue of being accessible from within the U.S. via an automated trading system. The CME agrees with the CFTC that, at some level of activity in the U.S., a foreign exchange cannot qualify for an exemption and must become designated as a U.S. contract market. In comment letters submitted in response to the Concept Release, different criteria were suggested as to how that line should be drawn. The CME proposed that if a substantial portion of the overall trading volume of a foreign exchange for two consecutive quarters originates from terminals in the U.S., then the exchange should be required to be designated as a U.S. contract market. The Chicago Board of Trade suggested that the test should be whether the foreign exchange's products are based on U.S. securities or interest rates, whether the primary cash market for the product is located in the U.S., and whether the delivery and settlement procedure is subject to U.S. law. The New York Mercantile Exchange proposed that the test should be whether the products are physically delivered in the U.S. or are settled by reference to prices derived from U.S. markets, because of the potential impact on the pricing integrity of the U.S. markets. The CME believes that there is merit in each of these suggestions.

### **Interim Relief for Foreign Exchanges**

At the CFTC's roundtable discussion on April 20, 1999, representatives of foreign exchanges expressed frustration at how long the process was taking to allow them to install trading terminals in the U.S. (or additional terminals in the case of Eurex) connected to their respective automated trading systems. The foreign exchanges did not want that issue linked to the issue of the need to lower regulatory requirements imposed on U.S. exchanges. The foreign exchanges therefore proposed that the CFTC resume issuing no-action letters, or grant some other form of interim relief, that would allow them to install terminals in the U.S., while the question of regulatory relief for U.S. exchanges would be handled on a separate track.

Although the CME understands the position of the foreign exchanges, we cannot agree with their proposed solution. From our viewpoint, it is essential to link regulatory relief for U.S. exchanges to the requests of foreign exchanges to have electronic access to persons in the U.S. Otherwise, there will be no level playing field. Nothing would prevent the foreign exchanges from listing whatever contracts they choose (including futures on Eurodollars and on U.S. Treasury bonds) and offering such contracts to be traded electronically by persons in the U.S. via a DES or an AORS under more favorable regulatory conditions than are allowed for U.S. exchanges. That is an intolerable result from the perspective of the CME and other U.S. exchanges.

Commissioner Holum, in her remarks issued after the April 20 roundtable, stated that she was in favor of lifting the moratorium and instructing the CFTC's Office of General Counsel to begin immediately processing no-action requests from foreign boards of trade seeking to place trading terminals in the United States. At the same time, in order to assure regulatory parity between U.S. and foreign electronic trading systems, Commissioner Holum would have the Commission commit to provide regulatory relief as needed to ensure that the electronic trading systems operated by U.S. exchanges will be subject to the same standards as those required for placement of foreign terminals in the U.S. The CME commends Commissioner Holum for her diligent efforts to seek a solution to this regulatory conundrum. Unfortunately, her latest proposal does not satisfy the needs of the U.S. exchanges. Under her proposal, foreign exchanges will receive no-action letters allowing them to install terminals in the U.S.; however, the relief required by U.S. exchanges requires a formal exemption under Section 4(c) of the Act. Even with the best of intentions, it is easy to imagine the proposed exemption for U.S. exchanges getting bogged down while foreign exchanges are able to operate terminals in the U.S. at a comparative regulatory advantage.

Our proposal for regulatory parity need not delay foreign exchanges from installing terminals in the U.S. To the extent that a foreign exchange allows a practice that is not allowed for U.S. exchanges under the Act or CFTC regulations, the foreign exchange can simply agree not to allow such practice with respect to electronic access from the U.S. via a DES or an AORS until such time as the practice is allowed for U.S. exchanges. Only by linking the practices allowed for foreign exchanges and U.S. exchanges with respect to electronic access from the U.S. to their automated trading systems can fair competition between them be assured.

**The Same Rules Should Apply Whether the Electronic Access is Provided Via a DES or an AORS.**

The CME's comment letter on the Concept Release, dated October 6, 1998, set forth our position as follows: "The CME believes that the CFTC rule should cover all types of systems that provide electronic access for participants in the U.S. to the foreign board of trade. The specific type of technology is not relevant to the CFTC's regulatory concerns. Any type of system that provides such access, whether it be labeled an electronic trading system or an order routing system is intended to solicit trading by U.S. participants and thus raises the same regulatory need for rules proscribing fraud and performing the other functions specified in Section 4(b) of the Act." The CME continues to believe that that position is correct.

At the April 20 roundtable, representatives of the Futures Industry Association ("FIA") acknowledged that some form of regulatory approval, albeit less formal than that contemplated in proposed Rule 30.11, is appropriate when a foreign exchange seeks to install terminals in the U.S. that are part of a DES. The FIA also argued that there should be no regulatory approval required when U.S. persons obtain electronic access to the automated trading system of a foreign exchange via an AORS. The CME strongly disagrees with the FIA's position on this issue.

Exchange automated trading systems can be operated either as a closed system or as an open system. In a closed system, the only way to access the host computer where trades are matched is through a dedicated terminal provided by the exchange. The original GLOBEX System developed by Reuters is an example of a closed system.

In contrast, most automated trading systems being developed today are open systems. Open systems provide interfaces that permit independent software vendors to develop front-end software packages that permit computers owned by a customer or an FCM to access the exchange's automated trading system. The CME's current electronic trading system, GLOBEX 2, is an example of an open system. As shown on the diagram attached hereto as Exhibit A, member firms can obtain access to GLOBEX 2 through their internal proprietary networks or through a terminal provided by an independent software vendor, as well as through a terminal provided by the CME. From a functional perspective, it makes no difference whether an order is entered through a firm's proprietary network as opposed to a terminal provided by the exchange.

The proposed CFTC rules would be totally ineffectual if they applied only to direct execution systems. If a foreign exchange could remove itself from the scope of the CFTC's proposed rules simply by relying entirely on third-party vendors and firm proprietary networks to provide the electronic access to the exchange's markets from persons in the U.S., then the proposed rules would become a meaningless exercise because no one would be subject to them. That result would also be inconsistent with the goal of fair competition between U.S. exchanges and foreign exchanges. Foreign exchanges pose the same competitive threat to U.S. exchanges regardless of whether electronic access to their markets is provided via a DES or an AORS.

**Comments on Proposed Rule 1.71**

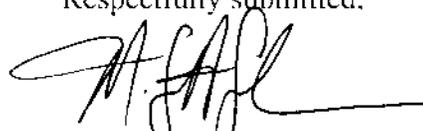
Proposed Rule 1.71 goes beyond the issue of foreign terminals in the U.S. The proposed rule would establish standards for all order routing systems that route orders to an automated trade matching system operated by either a U.S. or a foreign futures exchange. The standards include such things as credit controls, position limits, the capability to block a customer's entry of orders and reasonable safeguards to ensure against unauthorized access, unauthorized trading and unauthorized disclosure of customer orders.

The FIA argued that proposed Rule 1.71 is not needed, pointing out that Rule 1.16 already requires that an FCM have in place appropriate internal accounting controls and procedures for safeguarding customer and firm assets. The CME agrees with FIA that the CFTC has not demonstrated that more detailed, prescriptive rules governing order routing systems are necessary. To the extent that the standards that would be established by proposed Rule 1.71 reflect common sense requirements that users of an order routing system would want to have, we believe that competition and market forces will achieve the same results.

**Conclusion**

The Commission should allow electronic access between foreign exchanges and persons in the U.S., but only by simultaneously acting to permit U.S. exchanges to compete with the foreign exchanges on the same regulatory terms. In connection with any no-action relief or exemption granted to a foreign exchange, the Commission should exercise its authority under Section 4(c) of the Act to permit U.S. exchanges to operate under the same standards and conditions that govern the foreign exchanges with electronic access to U.S. persons. If the Commission is unwilling or unable to afford U.S. exchanges exemptive relief within the planned time frame for granting relief to foreign exchanges, then electronic access from U.S. persons to foreign exchanges should be allowed only on the condition that they abide by the regulatory constraints set forth under the Act and CFTC regulations until such time as those constraints are modified for U.S. exchanges.

Respectfully submitted,



M. Scott Gordon

MSG/dft:4306  
Enclosure

cc: Chairperson Brooksley Born  
Commissioner Barbara P. Holum  
Commissioner David Spears  
Commissioner James Newsome  
Mr. I. Michael Greenberger

## GLOBEX<sub>2</sub> SYSTEM COMPONENTS

