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CHICAGO MERCANTILE EXCHANGE

James J. McNulty
President and CEO
312/930-3100
FAX: 312/648-3625
Email: jmcnulty@cme.com

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COMMENT

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

RE: Proposed revision of the Commission's procedure for the review of contract market rules

Dear Ms. Webb:

On November 17, 1999, the Commission took two actions concerning oversight of exchange contracts and rules. First, the Commission approved new Rule 5.3 that permits exchanges to list new contracts for trading without CFTC approval. Second, the Commission proposed revisions to Regulation 1.41 to allow exchanges to adopt new rules and rule amendments without CFTC approval. Because these two actions are closely related, some of our comments on the proposal to revise Regulation 1.41 will also apply to Rule 5.3.

These actions represent a significant departure from the Commission's previous position that exchanges must submit new contract applications and proposed rule amendments to the CFTC for review and approval. The CME applauds the Commission for taking these steps toward granting meaningful regulatory relief for U.S. exchanges. The CME supports the Commission's use of its exemptive authority under Section 4(c) of the Commodity Exchange Act ("Act") to grant such relief. The proposed revisions to Regulation 1.41 have many positive features, and we believe that adoption of those revisions will help to resolve some of the problems that we have with Rule 5.3.

Under Rule 5.3, an exchange can list and start trading a new contract without needing CFTC approval by submitting a copy of the contract's terms and conditions to the CFTC, along with a certification that the contract's terms and conditions are consistent with and do not violate the Act or the CFTC's rules. (A contract that is listed pursuant to this procedure will be referred to as a "certified contract," as distinguished from a "designated contract" that has been approved by the CFTC.) Certified contracts must be identified as such in the exchange's rulebook on the ground that "the public has the right to know the legal status of a contract." Rule 5.3 authorizes an exchange to implement amendments to a certified contract's terms and conditions only in trading months having no open interest.

The proposed revisions to Regulation 1.41 would provide a new procedure by which an exchange can place a new rule or rule amendment into effect without CFTC review or approval. The exchange would submit to the CFTC the text of the rule or rule amendment, together with a certification that the rule complies with the Act and the CFTC's rules. An exchange therefore could not use this procedure to put into effect a rule that is inconsistent with the Act or CFTC's rules.

Because this new procedure would be available only to exchanges that have been designated as a contract market for at least one contract, it would not be available to a new start-up exchange. The CME supports this provision. We continue to believe that the initial designation of a board of trade as a contract market properly entails a more lengthy review and analysis of its trading and clearing systems and its self-regulatory programs.

The CFTC proposal also provides that transactions by market participants effected subject to a rule implemented pursuant to this new procedure shall not be void or voidable as a result of (i) a violation by the exchange in implementing the rule under this procedure or (ii) the CFTC's subsequent disapproval of the rule. This provision is intended to provide legal certainty to market participants for transactions effected under rules that were implemented pursuant to this new procedure. The CME believes that promoting legal certainty is a desirable objective, and we support this provision.

In the Federal Register release accompanying the text of the proposed revisions to Regulation 1.41, the Commission requested comments on five specific issues. Our position on those issues is based on the following principles:

- Exchanges should be free to adopt and amend rules in accordance with their business judgment and should take responsibility for their actions.

- The CFTC should function as an oversight agency and should not be involved in reviewing and approving exchange rules.

Based on those principles, our specific comments on the five issues are set forth below.

1. Exclusivity of Regulation 1.41(z) Process

As proposed, the new Regulation 1.41(z) procedure is an alternative to the existing procedures by which exchanges submit proposed rule changes to the CFTC for review and approval. The Commission requested comment on whether the new procedure should be the exclusive means of implementing rule changes that are eligible for that procedure, rather than giving exchanges the choice of using the existing procedures instead. The Commission similarly

asked whether the procedure under new Rule 5.3 should be the only means by which an exchange can list a new contract for trading.

The CME believes that exchanges should have the maximum flexibility possible in deciding which procedure to use in listing new contracts and implementing rule amendments. As noted in the CFTC's release, an exchange gains certain protection against attacks under the antitrust laws if the rules in question have been affirmatively approved by the Commission. An exchange might well decide to seek CFTC approval of a rule that raises significant competitive issues, but rely on the new Regulation 1.41(z) procedure for less controversial rules. The CME also believes that the method by which a new contract is listed for trading should not limit an exchange's flexibility in choosing the procedure it wishes to use in amending certain terms and conditions of that contract. For example, we believe that an exchange should be allowed to amend the terms and conditions of a contract — regardless of whether the contract was designated by the Commission or certified by the exchange pursuant to Rule 5.3 — by using either the new Regulation 1.41(z) procedure or the traditional Regulation 1.41(b-d and h-t) procedures.

The only reason suggested for not giving exchanges this flexibility is a concern that allowing alternative procedures for amending exchange rules "may create confusion for market participants with respect to the regulatory history of rules and may lead to the inaccurate impression that rules adopted pursuant to Regulation 1.41(z) or 5.3 have been reviewed by the Commission." But this concern assumes — incorrectly, in our view — that market participants care about the regulatory history of rules. Under existing Regulation 1.41, some exchange rules are approved by the Commission; others are approved by staff pursuant to delegated authority; and still others are permitted to go into effect without any approval. We have never received a request from a market participant asking us to identify the procedure by which an exchange rule became effective. Because the Commission's proposal provides legal certainty to market participants that their transactions will not be voidable if effected under rules that were implemented under the new procedure, it should make no difference to them which procedure was used in implementing exchange rule amendments.

For the same reasons, we believe that the requirement in Rule 5.3 that an exchange identify contracts in its rules as "listed for trading pursuant to exchange certification" is unnecessary and inappropriate. If our comments about giving exchanges flexibility on how to implement rule amendments are accepted, then certain terms and conditions of a contract will be affirmatively approved by the Commission, and other terms and conditions of the same contract will not. It would become an administrative burden for exchanges to maintain a current listing of the regulatory history of every rule and every contract term. (In 1999 alone, the CME amended its rules more than 200 times, including some cases where the same rule was amended on more than one occasion.) There is no need for such a listing. Indeed, Rule 5.3 explicitly provides that all sections of the Act and CFTC rules which refer to "designated contract markets" are applicable to contracts listed for trading pursuant to Rule 5.3.

2. Suspension of Effectiveness of a Rule

The Commission noted in its release that, under the Act, the Commission must provide notice and an opportunity for a hearing before an exchange rule may be disapproved or altered. It requested comments on whether it should reserve the authority to stay or to suspend the operation of an exchange rule once disapproval proceedings have been initiated.

The CME believes that rules adopted by an exchange should be presumed to be lawful and valid. We therefore believe that the Commission should not have the authority to stay or to suspend the operation of an exchange rule simply because disapproval proceedings have been initiated. In an emergency situation, the Commission has authority under Section 8a(9) of the Act to direct a contract market "to take such action as in the Commission's judgment is necessary to maintain or restore orderly trading in or liquidation of any futures contract . . . ." The Commission can take such action without providing advance notice or a hearing.

3. Contracts With Open Interest

Under recently adopted Rule 5.3, an exchange is not allowed to use the new certification procedure to amend contract terms and conditions for contract months with open positions. The Commission requested comments on whether the new Regulation 1.41(z) procedure should be available for rule amendments relating to contracts that have open interest.

In responding to this question, we believe that it is important to distinguish among three types of exchange rule amendments. First, there are amendments to rules of general application. Examples would include rules that prescribe trading procedures for contracts that are traded by open outcry and/or through the CME's GLOBEX® Electronic Trading System. Although amendments to this type of rule will affect trading in all contracts, including those with open interest, there is no special reason why CFTC review and approval of such rule amendments is needed. Indeed, if this type of rule amendment is not eligible for the new procedure, that procedure would afford very little relief to U.S. exchanges.

Second, certain rule amendments alter the terms and conditions (as defined in Regulation 1.41(a)(2)) of a particular contract that has open interest, but without affecting the pricing of the contract. Examples of this type of rule amendment include changes to the size of the contract, the minimum trading increment, trading hours, price limits and position limits. The CME believes that the new procedure should be available for this type of rule amendment.

Third, certain rule amendments may alter the terms and conditions of a particular contract in such a way as to have a possible effect on the pricing of the contract. For example, in 1996, the CME submitted a rule amendment to change the settlement procedures for its Eurodollar futures contract. The final settlement price of the Eurodollar futures contract previously had been

determined by a survey of London banks conducted by the CME. The results of the CME survey varied slightly – but not systematically – from the results of the comparable survey conducted by the British Bankers' Association ("BBA"), which was and is the benchmark for most interest-rate swap agreements. Because many swap dealers use Eurodollar futures to hedge their swap exposure, they asked the CME to adopt the BBA settlement for Eurodollar futures in order to avoid any basis risk between swaps and futures. This change, which was supported by the vast majority of market participants, had a potential effect on the pricing of open Eurodollar futures positions. It clearly would have been an unacceptable response to say that this change could be made effective only for contract months with no open interest, given that contract months were listed out ten years into the future and open interest was in the millions. A ten-year phase-in of the change would have been confusing and costly to the users of the contract.

The CME believes that exchanges should be trusted to use the new procedure to implement rule amendments without CFTC review or approval for all types of amendments, even those that might affect the pricing of contracts with open interest. Exchanges need to protect their business reputations and the integrity of their markets. Exchanges know that if they were to adopt a rule amendment that affects materially the prices of open positions in an arbitrary or capricious manner, market participants would tend to avoid trading at such exchange. We therefore believe that it is not necessary to require such rule amendments to be subject to prior CFTC review and approval. (Assuming that the Commission allows exchanges to use the Regulation 1.41(z) procedure for rule amendments relating to contracts that have open interest, conforming changes should also be made to the text of Rule 5.3.)

4. Emergency Rules

The Commission noted in its release that the Act contains special provisions for the implementation of contract market rules on an emergency basis. The Commission adopted Regulation 1.41(f) to implement those provisions. The Commission requested comments on how to differentiate emergency rules adopted pursuant to Regulation 1.41(f) from other rules that could be adopted pursuant to proposed new Regulation 1.41(z).

The CME recognizes that Congress mandated a special procedure for implementing contract market rules in the event of an emergency. The term "emergency" is defined in Regulation 1.41(a)(4). We believe that any exchange rule adopted in response to an "emergency" as defined in Regulation 1.41(a)(4), except for paragraphs (v) (dealing with physical emergencies) and (viii) (general catch-all), should be handled in accordance with the special procedures of Regulation 1.41(f). One advantage of adopting a rule through emergency action pursuant to Regulation 1.41(f) is that the rule can be made effective immediately, whereas a rule adopted under proposed new Regulation 1.41(z) cannot become effective until the day after it is submitted to the CFTC. We note that our suggestion is similar to the approach taken in Regulation 1.69, which requires that special conflict-of-interest screening be performed in the case of rule changes which address an "emergency" as defined in Regulation 1.41(a)(4).

5. New Electronic Trading Systems

The Commission requested comments on whether proposed rules implementing a new electronic trading system at an existing contract market should be processed under the new procedures of proposed new Regulation 1.41(z). As noted above, the CME believes that the new procedure should not be available to a start-up exchange because of the need for the Commission to review in depth a new exchange's trading and clearing systems and its self-regulatory programs. Similarly, we believe that it is appropriate for the Commission to review newly created electronic trading systems. However, once the Commission has determined that an electronic trading system satisfies the applicable standards, the Commission should not be involved in reviewing upgrades and enhancements of such system.

In conclusion, we urge the Commission to continue moving in the direction of regulatory reform by adopting proposed Regulation 1.41(z) and thus allowing U.S. exchanges to adopt new rules and rule amendments without Commission review and approval.

Respectfully submitted,

James J. McNulty

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