Chicago Mercantile Exchange

Terrence A. Duffy
Chairman of the Board

James J. McNulty
President & Chief Executive Officer

August 1, 2002

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

RE: Statement before the Commission's
Roundtable on Derivatives Clearing Organizations

Dear Ms. Webb:

Chicago Mercantile Exchange ("CME" or "Exchange") is pleased to offer this statement regarding the issues that are slated to be discussed at the Commission's Roundtable on Derivatives Clearing Organizations on August 1, 2002.

It is our understanding that the Roundtable has been organized specifically in response to issues raised before the Hearing on Commodity Futures Trading Commission Rules Relating to Intermediaries on June 6, 2002. At that Hearing, the Commission heard testimony from a number of sources citing broad structural concerns regarding competition – or the perceived lack thereof – within the domestic futures industry. In particular, some have questioned the organizational structure of exchanges such as CME, which has operated a vertically integrated execution, clearing and settlement facility for approximately one hundred years.

As a preamble, let us underscore our continued, deep commitment to serve the needs of the futures trading community, including our important clearing member firms and their customers. We clearly recognize that the interests of the Exchange must be aligned with the interests of our customers in order to assure our mutual prosperity. Thus, this letter is offered in the hopes of promoting a full appreciation of the intent and strategies of CME to achieve a more complete alignment.

1. Competition

At the recent Hearing, Mr. John Damgard of the Futures Industry Association ("FIA") remarked – and we concur - that "competition ... [is] ... the best regulator." But he further observed that "[w]ith the exception of BrokerTec, we have seen remarkably little competition ... [with respect to existing products] ... at either the exchange or clearing organization level. The regulatory barriers to entry may have been removed, but the vigorous rivalry that we had hoped for has not broken out." [1]

As a possible means of encouraging competition, Mr. Damgard suggested two prescriptive remedies in the form of (1) fungibility; and (2) common clearing. Fungibility and common clearing are of course characteristic of the domestic securities industry – where standardized transactions on multiple trading platforms might be routed for clearance to a single clearing organization operated akin to a utility.

Before rushing headlong into any attempt to restructure our industry through the process of regulation, it is prudent to consider what we regard as "the three pillars of our legacy: financial integrity, liquidity and innovation." To succeed and to serve the best interests of the marketplace as a whole, we must be cognizant that "our legacy depends not on one or another ... but on all three." [2]

Diversity of Business Models – CME has traditionally pursued a vertically integrated business model, housing all functions from product and marketplace development, promotion, trade execution, clearing and settlement under one roof. As such, Mr. Damgard's prescriptions for fungibility and common clearing – a business model where front-end functions are fragmented amongst a number of entities distinguished from a consolidated back-end service provider – might be regarded as an antithesis of sorts of the vertically integrated model practiced by CME.

Some have even likened the vertically integrated business model to that of a monopoly. But ... "[o]ver the past three decades, almost every textbook example of a 'natural monopoly' has been shown to be anything but – not electricity generation, nor telecoms, nor lighthouses ... What matters in these markets are not current market shares, but the possibility of new market entries. A firm, no matter how high its market share, will always be concerned about the possibility of new competitors stealing its clients, undercutting its prices, and destroying its profitability. In the final analysis, it will behave almost exactly as it would in a fully atomistic market. Market entry, however, is easy, or so the experience of the last few years has shown." [3]

---

[1] Statement of Mr. John M. Damgard, Chairman and President, Futures Industry Association, "Public Hearing on the CFTC Study of Potential Changes in the Regulation of Intermediaries," June 6, 2002.
[2] Statement of Mr. Leo Melamed, Chairman Emeritus, Chicago Mercantile Exchange, "Federal Reserve Bank Roundtable on the Institutional Structure of Financial Markets," February 15, 2002.
[3] "Managing Growth in the Securities Process Chain," Prof. Dr. Werner Seifert.

Thus, we ask you to consider that *diversity* of business models – not homogeneity – is the keystone to true competition in any industry. If competition is indeed the best regulator, as we both agree, the vertically integrated model must be allowed to compete alongside any other business models that may be devised – including the security industry model featuring a "horizontally" aligned, common clearing facility.

Competition for Derivatives Business -- Mr. Damgard has suggested that there is a dearth of serious competition with respect to existing futures contracts. We respectfully disagree to the extent that we are keenly aware of competition from any number of product offerings serving identical or similar purposes that CME products are designed to address within the derivatives marketspace.

Our flagship Eurodollar contract, for example, faces stiff competition from the extraordinarily large and successful market for over-the-counter ("OTC") interest rate swaps ("IRS") and from forward rate agreements ("FRAs"). In addition, we note that Eurodollar contracts have been offered on other domestic and foreign exchanges from time to time.

Our stock index contracts are offered under licensing agreements with index publishers that offer a limited degree of exclusivity. However, this exclusivity is far from comprehensive. In particular, our stock index markets are assailed by competition from options on the very same indexes offered on stock option exchanges; from Exchange Traded Funds ("ETFs"); from index-based mutual funds; and, OTC equity derivatives. Please consider that while various exchanges may offer stock index products based upon somewhat different underlying indexes, these indexes may represent the same essential underlying risks and therefore serve redundant economic purposes.

Our currency complex represents a relatively small slice of the currency derivatives marketplace – which is of course dominated by interbank trade of currency forwards, swaps and options. We further note that CME is hardly the sole exchange that offers currency futures – facing direct competition both domestically and abroad.

We note that even vocal proponents of measures such as common clearing recognize competition within the domestic futures industry – competition that is facilitated by the emergence of electronic trading systems ... "We've got ICE coming in, in terms of energy. We've got BrokerTec, trying to copy financial instruments. We've got the Merchants Exchange, trying to do something on energy. We've got Island, trying to compete with One Chicago and QLX, even before equity futures get launched."[4]

---

[4] Statement of Mr. Jan R. Waye, Senior Vice President, Cargill Investor Services Inc., "Public Hearing on the CFTC Study of Potential Changes in the Regulation of Intermediaries," June 6, 2002.

Competition from the derivatives marketplace is incredibly stiff. In fact, statistics suggest that the futures industry is dwarfed by the magnitude of these competitors. We note with interest that critics of futures exchange practices have not attempted to extend their prescriptions to the derivatives markets which generally trade *sans* fungibility or the financial safeguards associated with clearing mechanism – horizontally or vertically aligned.

Notional Value of Outstanding Futures vs. Derivatives
(In Billion USD as of December 2001)

Interest Rate Futures		OTC Interest Rate Derivatives	
Futures	$9,234.0	FRAs	$7,737.0
Options	$12,492.6	Swaps	$58,897.0
		Options	$10,879.0
Total	$21,726.6	Total	$77,513.0
Currency Futures		**OTC Currency Derivatives**	
Futures	$65.6	Forwards and swaps	$10,336.0
Options	$27.4	Currency Swaps	$3,942.0
		Options	$2,470.0
Total Currency	$93.0	Total Currency	$16,748.0
Equity Index Futures		**Equity Index Derivatives**	
Futures	$334.0	Forwards and swaps	$320.0
Options	$1,563.7	Options	$1,561.0
		ETFs	~$120.0 *
		Index Funds	$60.0+ *
Total Equity Index	$1,897.7	Total Equity Index	$2,061.0+
Grand Total	***$23,717.3***	***Grand Total***	***$96,142.0***

Source: BIS Quarterly Review, June 2002
* These figures are estimates – note that the Vanguard 500 alone accounts for approximately $60 billion in equity capital. Thus, this figure is very conservative as it does not account for the many more index funds available.

Competition is not limited to the product level but extends to the clearing organization level as well where various entities have recently registered as Derivative Clearing Organizations ("DCOs") including BrokerTec Clearing Company; EnergyClear Corporation; London Clearing House ("LCH"); and, The Options Clearing Corporation ("OCC") – in addition to pending application of Hedge Street Inc. – and the seven clearing organizations that were designated DCOs per the grandfather clause.

Diversity of Contract Designs – Unlike a security which exists independently and apart from any securities exchange, a futures contract is a non-generic, constructed product. It is typically designed by the staff of a futures exchange and is often unique in terms of its particular attributes, potentially invoking intellectual property issues. Because futures products are designed in such a way as to enhance the exchange value proposition, you will typically find that competing products in nascent markets are created with non-generic terms that reflect the exchange's unique judgment regarding market utility.[5]

Consider, for example, the recent competitions for agency and swap futures. The CME and the Chicago Board of Trade ("CBOT") developed agency and swap futures at roughly the same times – but with contract designs that diverged just a bit – in the case of agency futures – or quite significantly – in the case of swap futures.[6] Of course, the deployment of divergent contract designs based upon a common underlying risk precludes the possibility of fungibility.

Any attempt to force exchanges to adopt common design standards in the interest of fungibility detracts from competition based upon product innovation. Of course, we note that Mr. Damgard's comments were pointed more towards existing, rather than newly emerging, products. But the contract terms and conditions of even the most successful, established contracts are often refined and modified. Would you require an exchange to coordinate any such modifications with its competitors to promote fungibility?

Innovation – Exchanges – like any other business including brokerage firms – must be free to tinker and experiment in order to develop and refine products which will serve customers to the fullest extent, *i.e.*, to innovate.

---

[5] Diversity of contract design features sets futures apart from the securities marketplace. It further distinguishes futures from the stock option marketplace. Stock option contract terms and conditions are well established and generic – having been established by the Put and Call Dealers Association long before the introduction of the Chicago Board Options Exchange ("CBOE") in 1972. But consider that this might not necessarily be the case except for the fact that stock option design standards are in fact established per the Rules and By-Laws of The Options Clearing Corporation ("OCC") which is the common clearing organization for the stock option industry and which technically issues stock options. We may only speculate that the competition based on product advancements within that industry might be accelerated in the absence of this "back-end" driven model.

[6] The CME and CBOT agency futures contracts diverged slightly in terms of the conversion factor standards employed – the CME contract was based upon a 6.5% standard while the CBOT contract was based upon a 6% standard. The CME and CBOT swap futures differ much more significantly. The CME contracts are quoted per the "IMM Index" – or 100 less the quoted rate. CBOT swap futures are quoted in percent of par akin to CBOT Treasury futures contracts

In this regard, our record speaks for itself ... "Indeed, emulating the Chicago Laureate legacy of Milton Friedman, George J. Stigler, Merton M. Miller, Gary Becker, Robert Fogel, Robert E. Lucas, Jr., and Myron Scholes, Chicago's innovative soul is quite unique. Beginning in the 1850s with the inauguration of futures markets in the U.S., to the 1960s break from storable products, to the revolutionary introduction of financial instruments in the 1970s, to the development of security options contracts, to the 1980s induction of cash settlement in place of physical delivery, to the inception of mini-futures in the 1990s, Chicago markets have consistently been the incubator of innovation." [7]

Fungibility implies that exchanges share their design advancements with competitors and possibly forgo any benefits accruing thereby – the antithesis of innovation. At a minimum, enforced fungibility slows the pace of innovation. At its worst, it begs the question ... why innovate?

Common clearing by an industry utility likewise stifles innovation to the extent that a common clearing organization may be disinclined to devote resources to develop systems to support new and different contract design features. To the extent that a utility is established to serve the needs of the community, it may turn away any one member of the community that has even minimally unique needs.

We would argue that the derivatives industry is far from a mature industry but that growth opportunities abound. This is underscored by the recent volume and open interest growth in our businesses at the CME and in OTC derivatives. While economic conditions certainly promoted use of these markets, we would further cite innovations with respect to CME's electronic trading systems and the relatively recent introduction of our E-Mini products, designed specifically for that electronic environment, as significant marketplace and product design advancements. Very mature, static industries may be conducive to administration as a utility – growth markets may be stifled by the same.

Liquidity and Transparency – Mr. Damgard recognizes that "[i]t is no secret that liquidity is essential to the success of any futures contract." [8] We wholeheartedly concur and suggest that while CME's mainstream products may be identified as stock index, interest rate or currency futures – our major asset may be characterized as liquidity. But ... "liquidity is as elusive as it is vital." [9] Thus, we suggest that competition for existing products has not so much been precluded by structural considerations – rather it has sometimes been stymied by the difficulties of competing with markets that have rallied significant pools of liquidity.

---

[7] Statement of Mr. Leo Melamed, Chairman Emeritus, Chicago Mercantile Exchange, "Federal Reserve Bank Roundtable on the Institutional Structure of Financial Markets," February 15, 2002.
[8] Statement of Mr. John M. Damgard, Chairman and President, Futures Industry Association, "Public Hearing on the CFTC Study of Potential Changes in the Regulation of Intermediaries," June 6, 2002.
[9] Statement of Mr. Leo Melamed, Chairman Emeritus, Chicago Mercantile Exchange, "Federal Reserve Bank Roundtable on the Institutional Structure of Financial Markets," February 15, 2002.

Liquidity is a nebulous concept that is difficult to define but easy to recognize -- measured in terms of a market's tightness, depth, immediacy and resiliency. It is likewise difficult to achieve – appearing to depend upon mustering some critical mass of interest, participation and price competition by a diverse group of liquidity providers, commercial and public participants.

But once that critical mass is achieved, futures market participants invariably gravitate to the most liquid markets – to the exclusion of others. Thus, we would be pressed to identify multiple futures exchanges simultaneously and successfully trading substitutable products. This is further underscored by the propensity of house traders who are compensated on an incentive basis to resist possible suggestions from the house to direct trade to particular venues to the exclusion of others. Rather, these traders will seek the most liquid alternative.

So while there is no dearth of competition, the viability of such competition may be limited by the fact that traders consistently seek the most liquid market offerings ... "there are a lot of electronic 'wannabes.' There's insufficient liquidity to make any of them particularly viable yet." [10]

An instructive analogy may be found in the securities markets ... "[i]nvestment banks and other players in the industry launched one electronic exchange after another, usually to much fanfare, followed by a long embarrassed silence as the new *wunderkind* died an untimely death of low liquidity and teething reliability problems. Where exchanges are inefficient, perceived as unfair or hamstrung by regulation, these new entrants succeed in grabbing market share – as Island and Instinet in the U.S. have shown. That these attempts have fallen flat in Europe – from Tradepoint to Jiway, is because they offered little that wasn't being done, and better or cheaper, elsewhere." [11]

Intense price competition from many market participants results in a marshalling of liquidity. And an important by-product of the marshalling of liquidity implicit in successful futures markets is marketplace transparency. Transparency assures customers that competitive forces will be well informed if market prices should trade to levels inconsistent with prevailing conditions. Arbitrageurs can be relied upon to take advantage of aberrant price movements, restoring equilibrium balance. By contrast, markets characterized by fragmentation are often opaque, lending themselves to potential pricing abuse.

---

[10] Statement of Mr. Jan R. Waye, Senior Vice President, Cargill Investor Services Inc., "Public Hearing on the CFTC Study of Potential Changes in the Regulation of Intermediaries," June 6, 2002.
[11] "Managing Growth in the Securities Process Chain," Prof. Dr. Werner Seifert.

CME's business model represents a time tested method of marshalling that critical mass of liquidity necessary in support of a successful futures contract – and on a transparent basis. Still, we cannot reduce the process to a fixed formula – for every market we have introduced successfully, we have unsuccessfully attempted to introduce many more. The nebulous nature of liquidity is such that we continue – and will always continue – to experiment with and refine the formula in an attempt to build liquidity to a higher crescendo. There is no specific evidence that enforced fungibility – a measure that could serve to fragment the marketplace – may be more effective in promoting price competition.

Financial Integrity – Note that Core Principle 11 of Section 5(d) of the CEA requires Designated Contract Markets ("DCMs") to provide for the financial integrity of its contracts by establishing and enforcing rules "providing for the integrity of any contracts traded on the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization)." In this we have been highly successful as CME has never experienced even a single default – a statement that many horizontally aligned clearing houses cannot make. As such, we have been a bulwark for the highest principles under the CEA – "the reduction of systemic risk, the protection of customers, and the efficient operation of the markets." [12]

We recognize that the Commission allows for the retention of independent DCOs for these purposes. But in the final analysis, it is CME's considered belief that it can best discharge its responsibilities to insure the financial integrity of the marketplace by operating an integrated execution, clearing and settlement facility "so that at all times ... [we may monitor] ... the pulse of the entire marketplace."[13] Clearly, it would be counterintuitive to compel an exchange to assume responsibility for the operations of an independent clearing organization whose actions it cannot control or whose activities it cannot monitor closely.

[12] Statement of Mr. John P. Davidson, Managing Director, Morgan Stanley Dean Witter, "Public Hearing on the CFTC Study of Potential Changes in the Regulation of Intermediaries," June 6, 2002. Note that Mr. Davidson serves on the CME Risk Committee.
[13] Statement of Mr. Leo Melamed, Chairman Emeritus, Chicago Mercantile Exchange, "Federal Reserve Bank Roundtable on the Institutional Structure of Financial Markets," February 15, 2002.

2. Common Clearing

Common clearing implies efficiencies with respect to the use of capital, consolidated infrastructures and cost. Certainly these were the arguments that motivated efforts of just a few short years ago – initiated by the good offices of the FIA – to consolidate CME and Board of Trade Clearing Corporation ("BOTCC") clearing operations. Perhaps the timing was unripe or the specifics of the consolidation were inappropriate.

Still, the underlying motives were not lost on CME. Accordingly, we respectfully suggest that the CME Clearing House has actively pursued programs which achieve in large measure the stated benefits of common clearing.

Cross-Margining Programs – Common clearing implies the ability to offer margin concessions in recognition of offsetting positions in correlated markets. That is precisely the intent of CME's various cross-margining programs with other clearing organizations, incorporating most major derivatives market segments. We estimate that CME's cross-margining programs result in performance bond savings of approximately $350 million on a daily basis.

The Exchange's cross-margining systems generally require performance bonds in amounts that reflect the aggregate position of affiliated clearing members in specified products, relying upon the sophisticated risk-based systems of each clearing organization. Typically, the respective clearing organizations jointly hold a first lien on, and security interest in, the positions of cross-margined accounts. Performance bond deposits associated with these accounts are jointly held.

Cross-margining enhances both the efficiency and financial integrity of the clearing system by treating all positions as economically one – permitting gains accruing to futures or options positions to be immediately available to meet the requirements for funds from losing positions.

CME participates in a cross-margining system with the Options Clearing Corporation ("OCC") and the New York Clearing Corporation ("NYCC"). This system is applied to the accounts of market professionals and proprietary traders. The system has been developed in recognition of the economic linkage among the exchange-traded derivative products, the need to promote efficient clearing procedures and a focus on true inter-market risk exposures. CME had implemented a similar but separate program with the Board of Trade Clearing Corporation ("BOTCC") to cross-margin selected interest rate products. This program was subsequently terminated due to lack of use on the part of institutional market participants.

On March 31, 2000, CME implemented a cross margin agreement with the London Clearing House ("LCH") for select interest rate products. The LCH program differs from programs mentioned above to the extent that performance bond collateral is held separately at each respective Clearing House. This has the effect of relieving firms from the burden of balancing two separate position accounts.

Commencing June 17, 2002, CME implemented a cross-margining program with regard to E-Mini energy products offered on the New York Mercantile Exchange ("NYMEX"). In April 2002, CME implemented a cross-margining agreement with Government Securities Clearing Corporation ("GSCC") which recognizes the reduced risks associated with portfolios including certain U.S. Treasury securities and CME Eurodollar futures and options.

Clearing Interfaces/Banking Relationships – CME has actively endeavored to develop and conform to industry standards with respect to interfaces between the Clearing House and customers. We have worked closely, for example, with BOTCC and the FIA to standardize out-trade reports, trade record (TREX) formats and trade register reports. Further, we have been active in pursuing the standardization of give-up and average price system processes noting that our give-up billing system known as GAINS was jointly developed with BOTCC. Both CME and BOTCC worked closely with the FIA Chicago Operation Division Ad Hoc Committee on Uniformity during the period when a common Chicago clearing organization was discussed. These efforts continue insofar as we are now working with BOTCC and FIA representatives in pursuit of the next generation of messaging in the form of FIXml standards.

Common banking is another benefit of common clearing. CME and BOTCC initiated a Pilot Common Banking Program in June 1999. The Program represented a collateral allocation plan that allowed participating FCMs to freely allocate collateral to either participating clearing organization from special bank accounts jointly owned by the two clearing organizations. The program featured CME's Clearing 21 Banking and Asset Management facility as a single user interface. Only three FCMs participated in this program and it was terminated in January 2002.

Reliability – Vertically integrated operations promote system reliability by ensuring coordinated processing from execution through the clearing and settlement processes. Again, citing experience in the European securities industry ... "[t]he entire value-added chain of securities processing from the initial matching of trades and the determination of prices to the final steps in clearing and settlement has to work with extremely high reliability. Where new systems are very frequently introduced, and improvement is continuous, only vertically integrated organizations can combine innovation with the level of reliability that customers require." [14]

---

[14] "Managing Growth in the Securities Process Chain," Prof. Dr. Werner Seifert.

3. Costs

There is no compelling evidence that vertically integrated operations do not achieve cost savings on a level equal to or surpassing any other model in practice today. "On a post-netted basis, the different domestic settlement organizations in Europe … [which are vertically integrated within exchanges] … are as cost-efficient as the … DTCC … [whose operations vastly exceed the scope of these European settlement organizations] … A centralized agency is thus not necessarily cheaper than competing organizations."[15] In fact, we believe that a vertically integrated model actually reduces costs by diffusing the cost of overhead resources, facilities and software licenses.

Comparing Apples to Apples? – Mr. Damgard has questioned CME fee structures in support of his arguments … in reference to CME's E-Mini S&P 500 futures contract, he has noted … "[y]ou pay 39-cent-per side fee for clearing. You pay a 25-cent-per-side Globex fee. And you pay a Globex customer fee of 50 cents. So that adds up to $1.14 per side … And for comparison purposes, we picked the Dow Jones Euro … [STOXX contract] … that trades electronically at the Eurex. And that trades for 27 cents a side."[16] We respectfully believe that this comparison is misleading in a number of ways.

First, one might observe that the $1.14 CME fee applies to "customers" while the Eurex 30 EURO (~$0.30) fee applies to all market participants. But the weighted average fee charged to CME customers and liquidity providers reduces to $0.37.[17] One might further discount the CME fee to $0.22 recognizing that the notional value of an E-Mini S&P is ~170% as large as a Euro STOXX contract ($0.22=$0.37/1.7). This $0.22 CME fee compares favorably to the ~$0.30 Eurex fee. Second, please note that Euro STOXX futures are licensed exclusively to Eurex – an exchange which operates a vertically integrated execution, clearing and settlement facility. Thus, one cannot attribute these fee differences to structural issues.

A Valid Comparison – Perhaps a more appropriate comparison might be found in the form of CBOT's Mini $5 Dow contract – sized comparably, and offered as direct competition to CME's E-Mini S&P 500. The Mini $5 Dow contract entails customer transaction and clearing fees of $1.05 – not remarkably different than the $1.14 associated with the CME contract. CBOT also offers reduced fees to liquidity providers – like CME – effectively reducing weighted average fees. Note that this contract clears at the horizontally aligned and independent BOTCC. Again, it is unclear that these structural considerations impact upon fee schedules.

---

[15] "The Securities Settlement Industry in the EU," Lannoo & Levin, CEPS Research Report, December 2001.
[16] Testimony of Mr. John M. Damgard, Chairman and President, Futures Industry Association, "Public Hearing on the CFTC Study of Potential Changes in the Regulation of Intermediaries," June 6, 2002.
[17] Note that the distinction between locals and customers is not necessarily black and white with respect to fees. Fee discounts are frequently accessed by large end-users. Conversely, "liquidity providers" are not necessarily limited to floor traders but often include proprietary trading operations and other upstairs participants.

Recognized Value Leader – We concede that CME fees are structured to favor liquidity providers. This practice is intended to marshal liquidity in such a manner as to reduce the true total costs associated with trading, including fees and, notably, execution slippage. In this we have been most successful, as underscored by independent studies.

Goldman Sachs found that "commissions ... [including exchange fees and brokerage charges] ... represent only a small part of overall transaction costs for futures, typically well under 5% of total trading costs." Comparing CME E-Minis, ETFs and stocks ... "futures contracts are the cheapest to trade and ... stock[s] ... the most expensive. This is primarily due to higher commissions for stocks (and ETFs), a wider bid/ask spread, and higher market impact." [18] It is noteworthy that stocks and ETFs are traded on a fungible basis and cleared through common facilities.

Estimated Costs of Trading Futures, ETFs, Stocks

(Basis Points per $100 Million Notional Value)

	Standard S&P 500	E-Mini S&P 500	S&P 500 SPDR	Stock Portfolio
Commissions (Exchange+Brokerage Fees)	0.1	0.4	3.5	4.2
Bid/Ask Spread	1.5	1.5	2.5	5.0
Market Impact or Slippage	18.0	18.0	26.0	39.2
Total Trading Costs	19.6	19.9	32.0	39.2
Commissions as % of Total Costs	0.7%	2.2%	11.0%	10.6%

Source: Goldman Sachs Global Derivatives and Trading Research (April 4, 2002)

Some have applied the term "monopoly" in reference to vertically integrated exchanges. But ... "[t]he pricing behaviour of clearing houses proves that their monopoly rents are non-existent – clearers and settlement organizations owned by exchanges are actually cheaper than those owned by the intermediaries. And the market would never allow that one step of the value chain is subsidizing another ... [C]ompatibility of ... [the trading, clearing and settlement functions] ... can significantly lower the fixed costs, enabling higher asset productivity ... If you look at liquidity as an asset, it is more than beneficial to both the customers and the providers to leverage the productivity of the assembled liquidity over the entire securities processing chain. It goes without saying, that the openness of 'vertically integrated [exchanges]' ...is in the natural business interest of every manager of ... [an exchange]." [19]

[18] Goldman Sachs Global Derivatives and Trading Research (April 4, 2002).
[19] "Managing Growth in the Securities Process Chain," Prof. Dr. Werner Seifert.

4. Control

In the final analysis, this discussion is about control of the central source of value in any transactional equation – *the bid-offer spread.* This fact is underscored by Mr. Davis's recent testimony before the CFTC when he remarked that exchanges are ... "becoming private corporations primarily focused on the interests of their shareholders. The majority of their shareholders are locals whose interest is in maintaining the grip of the open-outcry system of futures trading. *This hold often prevents those customers who wish to take advantage of other forms of trading – such as internalization or crossing between major market participants* – from doing so, because of the rules requiring exposure to the floor." [Italics added for emphasis.] [20]

We share the concerns of Former SEC Chairman Arthur Levitt regarding such a result ... "the Commission is concerned about certain broker-dealer practices – internalization and payment for order flow – that substantially reduce the opportunity for investor orders to interact ... Reduced order interaction, if pervasive, may hamper price competition, interfere with the process of public price discovery, and detract from the depth and stability of the markets ... Price matching dealers thereby take advantage of the public price discovery process provided by other market centers ... but need not contribute to the process of price discovery ... This creates disincentives for vigorous price competition, which, if extensive, could lead to wider bid-asked spreads, less depth, and higher transaction costs. If these occur, all orders could receive poorer executions, not just the ones that are subject ... [to] ... internalization and payment for order flow arrangements." [21]

Similar controversies have erupted in European securities markets where ... "[t]he whole debate, disguised ideologically, is nothing else than an understandable dispute about the redistribution of the industry profit between the investors and issuers on the one side, and the intermediaries on the other side, with the ... [exchanges] ... being the turntable, market organization being the instrument of change, and the bid/offer spread being the desired target." [22] It is indeed unfortunate that the central issue has been obfuscated under the thin veil of enhanced competition. [23]

---

[20] Statement of Mr. Kevin Davis, President, Man Financial Inc., "Public Hearing on the CFTC Study of Potential Changes in the Regulation of Intermediaries," June 6, 2002.
[21] Testimony of Former SEC Chairman Arthur Levitt before the Senate Committee on Banking, Housing and Urban Affairs on Preserving and Strengthening the National Market System for Securities in the U.S., May 8, 2000.
[22] "Managing Growth in the Securities Process Chain," Prof. Dr. Werner Seifert.
[23] One might reasonably extend a prescription of fungibility and common clearing to over-the-counter interest rate swap ("IRS") markets as easily as to futures markets. A variety of derivatives desks offer their customers "plain vanilla" swap products – essentially identical contracts distinguished only with respect to the credit risk of the counterparty. These products lend themselves nicely to the concept of fungibility – with the *caveat* that regulators mandate common clearing – thereby rendering the counterparty credit risk of such instruments generic. However, we suspect that such a proposal might not be well received amongst the broker dealer community to the extent that such initiatives might erode the lucrative bid/offer spreads maintained in the fragmented and opaque IRS marketplace.

Exchange Governance – CME has recently demutualized, thereby transforming itself from a membership organization to a for-profit corporation which should serve to broaden the ownership in the corporation. Like any corporation, we have responsibilities to serve the interests of our shareholders. We must also serve the interests of our customers – noting that there is a healthy overlap between these two constituencies. As such, we are guided by an unforgiving market discipline requiring that we serve the interests of our customers in order to forward the interests of our shareholders. Accordingly, our policy is to emphasize an intense customer focus.

In light of the important forward steps we are making in this regard – at the vanguard of the domestic futures industry – we must respectfully disagree with Mr. Damgard's observation that "we have seen far less progress than we had anticipated in the evolution of exchanges. For example, the boards of directors of the major exchanges remain dominated by representatives of the floor community."[24] We invite clearing member firm representatives to participate in CME's governance by seeking election as Directors of the Exchange.

Open Outcry and Screen Trading – Mr. Damgard has suggested that "the transition from floor to screen has been halted at the halfway point, requiring FCMs to carry the financial burden of maintaining two trading systems on each exchange."[25] Note that CME's progress in this area is far from halted, with electronic trading continuing to grow rapidly as we witness the markets making the transition to an electronic platform in an intelligent manner.

---

[24] Testimony of Mr. John M. Damgard, Chairman and President, Futures Industry Association, "Public Hearing on the CFTC Study of Potential Changes in the Regulation of Intermediaries," June 6, 2002.
[25] Testimony of Mr. John M. Damgard, Chairman and President, Futures Industry Association, "Public Hearing on the CFTC Study of Potential Changes in the Regulation of Intermediaries," June 6, 2002.

But electronic trading systems are still in their relative infancy. We are, accordingly, reluctant to mandate migration to the screen and risk possible disruption of that potentially fragile alchemy of liquidity. Rather, we have operated floor and electronic trading venues on a side-by-side basis – providing FCMs and their customers with freedom of choice. If there was one clearly superior trading venue, that would be reflected in the marketplace. While the proportion of electronic trading has been growing swiftly on CME, the pace of this transition has been uneven in different market sectors.

Still, we have been diligent in our efforts to enhance the utility of our GLOBEX trading platform – witness developments including open access to the GLOBEX platform, the introduction of Lead Market Maker ("LMM") functionality and the impending introduction of implied spread ("EAGLE") functionality, amongst other enhancements. In further support of our commitment to electronic trading, we offer that – while Exchange headcount has remained relatively stable in the vicinity of near 1,000 employees, Information Technology ("IT") staff has tripled in size over the past three years. *I.e.*, we have invested and will continue to invest considerable time, funds and human resources towards the development of our electronic trading platforms.

We do so because we believe that the screen will eventually achieve that critical mass of liquidity that will cause most trading to be directed thereto. Accordingly ... "while it is mandatory to create the best electronic system that can be devised, while we must advance its use and effectiveness, the market and only the market, can dictate the timing of transference." [26]

Block Trading – An unfortunate perception plainly persists that "... in Chicago ... we are forced to put all orders into the pits; which means that if we have a large buy or a large sell, and even if we could find the other side of that, from a Morgan Stanley or from any other major player, we are forced to hit a bid or take an offer. And so we are routinely forced, on behalf of our customers, to leave a spread in the pit for the locals." [27]

---

[26] Statement of Mr. Leo Melamed, Chairman Emeritus, Chicago Mercantile Exchange, "Federal Reserve Bank Roundtable on the Institutional Structure of Financial Markets," February 15, 2002.
[27] Statement of Mr. Kevin Davis, President, Man Financial Inc., "Public Hearing on the CFTC Study of Potential Changes in the Regulation of Intermediaries," June 6, 2002.

This perception is contradicted by the availability of the block trading facility on CME. Block trading was introduced on the CME in November 2000. A block trade represents a privately negotiated futures or option transaction executed apart from the public auction market and governed by CME Rule 526, BLOCK TRANSACTIONS. This mechanism has been widely publicized and frequently utilized. Note, however, that block trading is subject to certain restrictions including a minimum quantity requirement and may only be practiced by Eligible Contract Participants ("ECPs") as defined in Section 1a(12) of the CEA.

These restrictions were adopted to reflect Commission policies and out of concern that uncontrolled internalization or crossing of orders on the part of firms may fragment market liquidity or obfuscate an otherwise transparent market pricing mechanism. In other words, to ensure the continued viability of an open, transparent marketplace – avoiding the negative results articulated by Mr. Levitt as cited above. [28]

Margin Policies – Mr. Davis further testified before the Commission that he finds it "increasingly disturbing that exchanges which do control their own clearinghouses are able to use their collateral levels or their margin requirements as a competitive influence ... The levels of margins are sometimes set with as much view to the competitive edge of the exchange as to the collateral required for the underlying product ... And I think it's inappropriate for those margin levels to be set by the exchanges themselves, because, after all, they're now for-profit businesses, they are interested in attracting as much business as they possibly can. The net loser is the FCM, because we're the ones who stand between the clearinghouse and the customer." [29]

This statement seems to be at odds with other inquiries we have received from the FIA questioning CME's practice of margining customer accounts on a gross rather than a net basis – begging the question – are performance bonds too high or too low? [30] These observations further contradict the hypothesis that there is a dearth of effective competition within the futures industry with respect to existing products.

We assert that CME's financial safeguard policies, including margin policies, are established with the sole purpose of protecting market participants from adverse credit events. These policies are in fact established per the direction of the CME Clearing House Risk Committee, comprised of six clearing member FCMs and a settlement banker, which is charged with the preservation of the financial integrity of our marketplace.

---

[28] It is illuminating to cite the frequency of block trading on BrokerTec – a facility owned by intermediaries. During the period December 2001 through June 2002, some 12.97% of the volume recorded on BrokerTec was blocked. On many days, the proportion was much higher, peaking at 82.79%. Note that some 0.10% of trades recorded on the CME were blocked during the same period.

[29] Comments of Mr. Kevin Davis, President, Man Financial Inc., "Public Hearing on the CFTC Study of Potential Changes in the Regulation of Intermediaries," June 6, 2002.

[30] Letter sent to candidates for election to the Board of Directors of Chicago Mercantile Exchange Holdings Inc. from the Futures Industry Association dated April 5, 2002.

5. Conclusion

The dual prescriptive remedies of fungibility and common clearing appear, superficially, to hold some appeal. They appear, superficially, to promote enhanced competition, to reduce transaction costs for the benefit of customers. But if the Commission were to enforce fungibility or common clearing, we fear that might prove fatal. In particular, we must recognize the underlying ambitions of the proponents of these measures and the resulting effects …

> "They want to internalize their dealings, take the markets upstairs and exploit the profit from the bid/ask spreads. In doing so, they will no doubt make lots of money, but there will be two fundamental casualties in their wake.
>
> "The first will be in the transparency implicit in the exchange-transaction-process, one that is vital to the world and its regulators. Need we explain the inherent dangers in the loss of transparency? If you want a glimpse of where lack of full disclosure in the marketplace can lead, you need look no further than the result of ambiguous account practices that were an accepted standard by many on Wall Street. Need we revisit the causes of the Enron debacle? …
>
> "The second casualty will be that of innovation. Does anyone here remember the last innovation produced by a utility?"
>
> "At least in part, this debate is an offshoot of the ongoing competitive debate between centralized exchanges and ECNs. Who provides the most efficient forum, the highest liquidity, the best price at the cheapest cost? Well the winner of that debate can only be determined by the ultimate arbiter – the marketplace itself. And although the jury is still out, there has already been some indication which way the verdict is leaning. Countless of would-be-competitive ECNs that were launched with great hoopla during the B2B bubble, now find themselves in the historical scrap-heap. Indeed, long before the terrorist attacks, there was growing recognition by participants that centralized exchanges provided the best combination of the ingredients necessary for safety and liquidity … That theme is amplified – by an order of magnitude – with the Enron experience." [31]

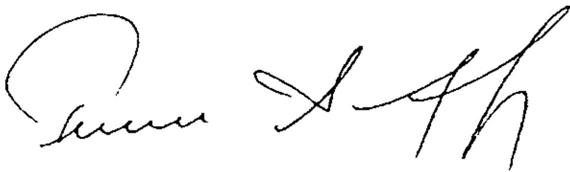
Accordingly, and in conclusion, we respectfully request that the Commission consider an alternate prescription … let the marketplace decide.

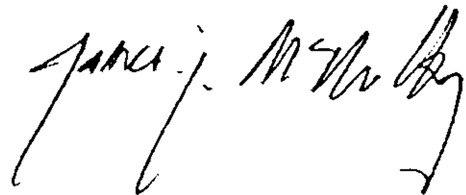
---

[31] Statement of Mr. Leo Melamed, Chairman Emeritus, Chicago Mercantile Exchange, "Federal Reserve Bank Roundtable on the Institutional Structure of Financial Markets," February 15, 2002.

We appreciate this opportunity to communicate our viewpoints with respect to these important issues and to participate in the Roundtable discussions scheduled for August 1st. We understand and appreciate the viewpoint of others within the industry with whom we may not always see eye-to-eye. And, we remain committed to serving the best interests of the futures community and look forward to continued dialogue in this regard.

Sincerely,





/jwl

CC: The Honorable James E. Newsome
The Honorable Barbara Pedersen Holum
The Honorable Thomas J. Erickson
Ms. Eileen Chotiner, Division of Clearing & Intermediary Oversight