



November 4, 2003

Via E-Mail

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

Re: U.S. Futures Exchange, L.L.C. Application for Contract Market
Designation

Dear Ms. Webb:

On September 16, 2003, U.S. Futures Exchange, L.L.C. (Eurex U.S.) filed an application for contract market designation with the Commodity Futures Trading Commission (Commission). That application indicated that NFA will conduct trade practice and market surveillance (TPMS) on behalf of Eurex U.S. The Commission has received two comment letters that question NFA's ability to provide regulatory services to Eurex U.S. As explained below, an unbiased review of the full record shows that those letters are clearly wrong.

NFA has a long history of operating efficient and innovative regulatory programs in a number of areas, including operational audits and financial surveillance, investigations and enforcement actions, and dispute resolution. The Commission has reviewed these areas on a number of occasions over the years and has never found any significant problems. In fact, the Commission has shown its confidence in NFA's regulatory programs by delegating a number of its own regulatory responsibilities to NFA. Additionally, NFA has taken on a number of new regulatory responsibilities over the years for new or previously unregulated products, such as security futures and retail off-exchange forex. NFA's track record shows that it has handled all of those responsibilities efficiently and effectively.

The Commission has reviewed NFA's TPMS program five times over the past three years and found each time that NFA was able to fulfill its responsibilities. NFA has entered into regulatory services agreements (RSAs) with four other exchanges that were seeking approval as contract markets, and the Commission performed an extensive review of NFA's TPMS program prior to approving each of those applications. The Commission also conducted a recent rule enforcement review of BrokerTec

Futures Exchange (BTEX) during which it reviewed the TPMS services that NFA provides to that exchange and found that NFA has adequate programs in place.

Comment letters filed by the Chicago Board of Trade (CBOT) and the Chicago Mercantile Exchange (CME) both insinuate that NFA does not have adequate resources to provide TPMS services to Eurex U.S. For example, the CME comment letter states that "NFA has not demonstrated that it possesses the resources or skills necessary to effectively monitor futures exchanges." These letters ignore NFA's demonstrated ability as a self-regulator as well as the expertise of NFA's TPMS staff.

NFA's TPMS staff reports to Yvonne Downs, the Senior Vice President of Compliance, who, prior to joining NFA in 2000, was employed by the CBOT for almost 20 years in various compliance-related positions. In 1995, the CBOT promoted her to Senior Vice-President and Administrator of the Office of Investigations and Audits. In that position, her responsibilities included the supervision of five regulatory divisions: audits, financial surveillance, investigations, market surveillance and regulatory reporting. Under Ms. Down's direction, NFA developed its own TPMS program. Collectively, members of the TPMS staff have 50 years working at futures self-regulatory organizations (including 28 years of exchange experience) and 15 years trading at the Chicago futures exchanges. In addition, NFA has cross-trained a number of members of its compliance staff to handle TPMS responsibilities, and these individuals are available to step in when needed.

The exchanges attempt to support their argument that NFA has not demonstrated its ability to provide TPMS services to Eurex U.S. by pointing to a single comment in the Commission's recent rule enforcement review of BTEX from November 30, 2001 to November 30, 2002. The review concluded that BTEX, using NFA's regulatory services, maintains adequate market and trade practice surveillance programs. The Commission has recently begun highlighting block trades and EFPs in its reviews, and it did say that NFA did not examine an adequate number of those transactions. As the CME neglected to mention, the Commission made a similar comment in its recent review of the CME's market surveillance program for the period September 1, 2001 to September 1, 2002, where it recommended that the CME modify its EFP program to ensure that the CME examines an adequate number of currency and interest rate EFPs.¹ As with any Commission recommendation, NFA took the Commission's comment seriously and responded by implementing appropriate procedures, and we assume the CME did as well. To suggest that this one comment calls NFA's competence into question is simply absurd.

The CBOT comment letter notes that, according to the BTEX rule enforcement review, NFA opened 11 trade practice inquiries and three trade practice investigations during the one-year target period. The letter then states: "BTEX's annual

¹ The Commission does not appear to have released a review of the CBOT's market surveillance program or a full review of its trade practice surveillance program since the CFMA adopted a core principle approach to exchange regulation.

volume for 2002 was 2,109,670 contracts. By comparison, Eurex traded over 800 million contracts in 2002. Although no one knows how well Eurex US will fare, its own expectations are that it will have vastly more volume than BTEX had last year. Therefore, the staffing and systems required to adequately conduct all of Eurex US's regulatory programs would be expected to be exponentially greater than what was necessary to conduct such programs for BTEX and the other small exchanges for which NFA currently performs similar services."

While NFA agrees that it takes more resources to provide TPMS services to a larger exchange, NFA is confident that it can provide the necessary resources whatever Eurex U.S.'s volume may be. As noted above, NFA has a number of individuals who have been cross-trained and can assume TPMS responsibilities on a moment's notice. Furthermore, the RSA between NFA and Eurex U.S. includes a volume-based charge that will provide NFA with the monetary resources to hire additional TPMS staff as volume grows. In any event, as the CBOT recognizes, it is unlikely that Eurex U.S. will start with volume anywhere near the 800 million contracts traded on Eurex.

The CBOT letter also claims that, in order for NFA to conduct its market surveillance function, NFA's staff must include economists who understand the cash markets and are familiar with cash market participants for Eurex U.S. products. NFA agrees that it must understand the cash markets and be familiar with their participants in order to fulfill its market surveillance responsibilities, but NFA does not agree that only economists are capable of doing so. NFA's TPMS staff has the necessary knowledge to surveil these products, and NFA will ensure that this remains true as additional staff are hired or transferred to the TPMS group in response to volume. Furthermore, if NFA determines that it needs one or more economists to handle this function, it will hire them.

The CBOT and CME comment letters also question whether NFA will have access to the information necessary to conduct an effective TPMS program. NFA staff conducts a due diligence inquiry before recommending that NFA enter into any RSA, and staff followed this same process in connection with Eurex U.S. As part of that inquiry, NFA staff performed a detailed review of Eurex U.S.'s proposed compliance rules to ensure that NFA would have the authority to obtain information from members of Eurex U.S. and their customers. NFA's review indicates that Eurex U.S.'s rules – and NFA's ability to obtain information – are practically identical to those for other U.S. exchanges, including the CBOT and the CME.

Eurex U.S. Rules 307(g) and 308(h) require members to furnish any information requested by Eurex U.S. or any of its agents – which includes NFA – in the course of their duties. Rule 309 is even more specific, making it a rule violation if a member fails to comply with a request for information by the entity authorized to conduct "market, trade practice, financial, and sales practice surveillance and related investigations and disciplinary proceedings" (i.e., NFA).

With respect to non-members who trade on Eurex U.S., Rule 616 gives the exchange the ability to order non-members and members that handle or clear their trades to appear, produce documents, and testify in a disciplinary matter. If a non-member declines, Eurex U.S. can order its clearing members to liquidate the non-member's positions, can prohibit members from accepting trades for the non-member, and can terminate the non-member's access. NFA would have direct access to the books and records of Eurex U.S. member FCMs for purposes of discovering the customer's identity, and Eurex U.S. Rule 307(a) requires non-U.S. brokers to provide this information to Eurex U.S. If NFA does not have direct access to necessary information, it will obtain that information from Eurex U.S. If NFA needs information from foreign persons, then, depending on the circumstances, it may take additional time to obtain that information, but this is no different than the process that established U.S. futures exchanges must go through.

The CBOT and CME comment letters note that Eurex U.S. is contemplating a clearing link with its German affiliate (Eurex) and question NFA's ability to obtain information regarding positions held on Eurex. Since the contracts listed on Eurex U.S. may be closely related, NFA may need access to certain information regarding positions carried on Eurex even without a clearing link. If NFA needs information regarding positions on Eurex, NFA can obtain that information directly from Eurex U.S. members carrying those positions and can request that Eurex U.S. obtain information from customers with positions on both markets. Therefore, in the absence of a clearing link, NFA believes that it has access to the information it needs to perform its regulatory services effectively.

NFA recognizes, however, that it will need greater access to information if a clearing link is established allowing Eurex U.S. positions to be initiated or offset on Eurex.² Although NFA would obtain the necessary information from Eurex U.S. in most instances, NFA may occasionally need to obtain information directly from Eurex. Therefore, NFA and Eurex U.S. have agreed that *before any mutual offset arrangement is implemented*, a formal procedure must be in place for NFA to have direct and prompt access to all necessary and appropriate information, including data relating to positions, trading and monies for any Eurex clearing firm, trader, and customer, so that NFA can perform trade practice and market surveillance services.

The CBOT's comment letter asks whether the RSA allows NFA to compel Eurex U.S. members to provide information to NFA regardless of instructions from Eurex U.S. As discussed above, Eurex U.S.'s rules require its members to provide information directly to a Eurex U.S. agent upon the agent's request, and those provisions include NFA. The RSA also acknowledges NFA's ability to request information directly from Eurex U.S. members. NFA will, of course, give Eurex U.S. regular updates on its activities, but if Eurex U.S. – or any other contract market that NFA has entered into an RSA with – attempts to interfere with an NFA investigation,

² NFA understands that this mutual offset feature is not part of Eurex U.S.'s contract market application but may be submitted to the CFTC for approval at a later date.

NFA will terminate the agreement and will be free to notify the CFTC of the reason for the termination.

In its comment letter, CBOT states that it is unclear whether Eurex U.S. has outsourced its audit and financial surveillance functions to NFA. NFA agrees that these are important functions. NFA has the systems, personnel, and expertise to perform these functions, and the RSA would cover these services if Eurex U.S. asks NFA to provide them.

The CME's comment letter states that Eurex U.S.'s application does not explain how NFA will assure that the costs for performing its functions on behalf of Eurex "are not being borne by other industry participants, like CME and other extant exchanges, which contribute significant funds to NFA."³ NFA's RSA with Eurex U.S. is priced so that NFA will recover its costs, and the pricing includes both a minimum monthly fee and a per contract fee. This ensures that the costs of the RSA will not be borne by other industry participants, regardless of volume.

In a footnote to the CME's comment letter, the CME claims that NFA does not have the authority to provide regulatory services to Eurex U.S. The footnote recognizes that NFA amended Article III, Section 1 of its Articles of Incorporation in 2001 to allow NFA to provide regulatory services but argues that "in proposing the amendment, NFA sought to provide services to evolving electronic exchanges and B2B exchanges that did not compete directly with existing exchanges." NFA staff has reviewed all of the Executive Committee and Board minutes and the explanatory material relating to the Articles' amendment, and nothing in those materials suggests that NFA cannot offer its regulatory services to exchanges that compete directly with existing exchanges. To the contrary, the legislative history of the amendment shows a deliberate intent to make NFA's authority as broad as possible.

Finally, the CME footnote contends that NFA is adopting, administering, and enforcing Eurex U.S. rules in violation of Article III, Section 2 of its Articles of Incorporation. The RSA does not authorize NFA to adopt, administer, or enforce any Eurex U.S. rules. NFA is merely a contractual service provider and will not make any decisions on behalf of Eurex U.S. NFA will investigate potential rule violations and will make its enforcement attorneys available to prosecute enforcement cases on an hourly basis, just as any hired law firm would do, but Eurex U.S. will determine whether to initiate a formal investigation, whether to issue a complaint, and how to resolve a charged matter.⁴

³ Most of NFA's funds come from public customers. The two largest futures exchanges – the CBOT and the CME – pay an aggregate assessment of \$300,000, which is approximately 1% of NFA's annual operating budget.

⁴ NFA will, however, conduct a preliminary investigation before referring a matter to Eurex U.S. for a decision on instituting a formal investigation.

NFA began operating as a registered futures association in 1982 with one overriding purpose – to protect customers and safeguard the integrity of the derivatives markets. NFA's unwavering commitment to that purpose over the years and its approach to fulfilling its commitment have earned it a reputation as an efficient, effective, and innovative self-regulator of the highest integrity. This reputation is NFA's hallmark, and NFA would not risk it at any price.

As discussed above, NFA's RSA with Eurex U.S. protects NFA from reputational and financial risk by ensuring that NFA has the resources and the information necessary to fulfill its responsibilities under the agreement. The RSA also gives NFA cancellation rights that NFA would exercise if Eurex U.S. were to impose barriers that make it difficult for NFA to perform the regulatory services required by the RSA and uncover wrongdoing. NFA would also exercise its cancellation rights if Eurex U.S. failed to address regulatory problems noted by NFA.

NFA is confident that the RSA and NFA's proven expertise will allow NFA to provide TPMS and other regulatory services to Eurex U.S. that comply with the Designation Criteria and Core Principles in Section 5 of the Commodity Exchange Act and Part 38 of the Commission's regulations.

Very truly yours,

Daniel J. Roth
President and Chief Executive Officer

cc: Chairman James E. Newsome
Commissioner Barbara Pedersen Holum
Commissioner Sharon Brown-Hruska
Commissioner Walt Lukken

ckm/ltr-dr/CFTC re Eurex 11-04-03))