



CHICAGO MERCANTILE EXCHANGE INC.

Craig S. Donohue
Office of the CEO
312 / 930-8275
Fax: 312 / 930-3209
cdonohue@cme.com

October 14, 2003

VIA MESSENGER

Ms. Jean Webb
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Center, 8th Floor
1155 21st Street, NW
Washington, D.C. 20581

**Re: HedgeStreet, Inc.'s Application for Designation
as a Contract Market and Derivatives Clearing Organization**

Dear Ms. Webb:

Chicago Mercantile Exchange Inc. ("CME" or "Exchange") welcomes the opportunity to comment upon HedgeStreet, Inc.'s ("HedgeStreet") Application for Designation as a Contract Market and Derivatives Clearing Organization (the "Application").¹ CME invented financial futures contracts more than 30 years ago and is currently the largest futures exchange in the United States and the largest derivatives clearing organization in the world. CME is also the only demutualized and publicly traded financial exchange in the United States. As an international marketplace, CME brings together buyers and sellers on its trading floors and GLOBEX® electronic trading platform. CME offers futures and options on futures primarily in four product areas: interest rates, stock indexes, foreign exchange, and commodities. Nearly one-half of all trading activity in our products is fully automated and transacted through the GLOBEX electronic trading platform. Our products compete with products traded in the over-the-counter derivatives, equity index options and cash securities markets, as well as competing futures and options markets around the globe. The Exchange moved about \$1.5 billion per day in settlement payments in the first half of 2003 and managed \$29.1 billion in collateral deposits at June 30, 2003.

¹ As used herein, the term "Application" includes all the publicly-available information that HedgeStreet has submitted to the Commission in support of its application. All terms capitalized herein and not otherwise defined shall have the meaning ascribed to them in HedgeStreet's Rules.

HedgeStreet's Application presents a unique exchange model. Unlike traditional exchange models, HedgeStreet's proposed Internet exchange will not permit intermediaries to join the exchange and not allow customers—or Members, as HedgeStreet refers to them—to leverage positions. Based upon these differences, HedgeStreet contends that it should be exempted from a plethora of the Act's Core Principles and Designation Criterion. HedgeStreet is wrong. Although HedgeStreet proposes a novel and untested model, HedgeStreet is required to comply fully with the Act in order to protect the interests of customers and maintain the safety and soundness of the clearing system. Under the Commodity Exchange Act (the "Act"), the Commission is charged with determining whether approval of HedgeStreet's Application is consistent with the requirements of the Act. The Exchange believes that the Commission should not approve the Application until: 1) the Exchange and other interested parties have been provided with adequate documentation to critically analyze and constructively comment upon HedgeStreet's proposal; and 2) HedgeStreet amends its operating, compliance, surveillance and disciplinary procedures and files an application demonstrating that it meets the designation criterion and core principles required for contract market and clearing organization status.

I. HedgeStreet's Proposal is Materially Deficient.

In support of its Application, HedgeStreet has submitted various documents to the Commission. Only three of these documents, however, have been released to the public. They are: 1) Appendix A, HedgeStreet, Inc.'s Rules (the "Rules"); 2) a chart entitled "Satisfaction of Designation Criteria and Compliance with Core Principles Applicable to Contract Markets and Derivatives Clearing Organizations" (the "Chart"); and 3) HedgeStreet's 2001 Application for Registration as a Contract Market and Derivatives Clearing Organization, dated March 12, 2001 (the "2001 Application").² Notably, HedgeStreet has chosen not to make public the current form of its Application or its purported regulatory services agreement with the National Futures Association (the "NFA").

Given the importance of these and other documents, on October 1, 2003, the Exchange asked the CFTC, pursuant to the Freedom of Information Act, to release the information that HedgeStreet is seeking to keep confidential. The Exchange believes that having the opportunity to review all documentation relating to HedgeStreet's Application is critical to allowing the Exchange and other interested parties to make an informed assessment of HedgeStreet's proposal. The Exchange also believes that HedgeStreet is required to make the information public pursuant to Designation Criterion 7 of the Act³

² In significant ways, the 2001 Application is not consistent with the Rules. We presume that the Rules reflect HedgeStreet's present intentions, but refer to the 2001 Application where appropriate.

³ Designation Criterion 7 provides that: "The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade."

and Core Principle 7 of the Act,⁴ both of which are designed to ensure that the public has broad access to a proposed exchange's rules and regulations. To date, however, the Exchange has received no such information pursuant to its October 1, 2003 request.

We believe that the Application is patently inadequate as a basis for public comment or Commission approval because it does not describe many of the most basic aspects of the operation and regulation of the proposed exchange. At a minimum, we urge the Commission to require HedgeStreet to supplement or amend the Application to fill in the holes and request the Commission to provide commentators another opportunity to submit comments.

II. The Application Violates the CEA.

The Application that HedgeStreet has submitted to the Commission is not consistent with the Act. The Application not only contains deficiencies, but raises important questions concerning Commission policy. For the reasons discussed below, the Commission should not approve the Application.

A. Organizational and Membership.

The organizational structure of HedgeStreet raises a number of problematic issues. First, the 2001 Application states that HedgeStreet is a corporation and a "wholly owned subsidiary of Pareto Partners Ltd. ("Pareto")."⁵ As the owner of HedgeStreet, Pareto is thus likely to have significant control over HedgeStreet's operations, particularly since Pareto will presumably have the power to appoint the executive officers of HedgeStreet, including the president. The president, in turn, will have the power to appoint all the directors of HedgeStreet's board,⁶ as well as "manage the day-to-day business of the exchange."⁷ There is, however, scant public information about Pareto and even less information about the two owners of Pareto, Dr. John Nafeh and Ursala Burger. Moreover, there is no information about the "president" or any of the executive officers.⁸ The adequate disclosure of the identity and background of Pareto, its owners and management team are critical to our ability to comment meaningfully on HedgeStreet's

⁴ Core Principle 7 provides that: "The board of trade shall make available to market authorities, market participants, and the public information concerning—(A) the terms and conditions of the contracts of the contract market; and (B) the mechanisms for executing transactions on or through the facilities of the contract market."

⁵ See 2001 Application at 52.

⁶ 2001 Application at 53-54.

⁷ *Id.*; See also, Rule 1.3.

⁸ *Id.*

Application. Until HedgeStreet provides this information to the public, the Commission should not approve the Application.

Second, despite the vast control that Pareto may have over HedgeStreet's operations, Pareto does not appear to be registered with the Commission in any respect. Pareto would thus not be accountable to the Commission in the same manner as registered entities. The Commission should not approve a contract market designation in a circumstance where, as here, the contract market's controller may extend beyond the Commission's regulatory reach.

Third, Pareto, Nafeh and Burger do not appear to have any futures or financial markets expertise or experience. According to the 2001 Application, Pareto "specializes in making early-stage investments in information technology companies that provide Internet-based products or services."⁹ Nafeh has "experience in general management, start-up financing, strategic planning, marketing, international joint ventures, and mergers and acquisitions in the high technology arena"¹⁰—in other words, just about everything except futures. Burger's expertise "is in corporate marketing and communications, corporate identity development, market research, international marketing, and public and investor relations activities."¹¹ Again, no mention of futures experience. Finally, HedgeStreet provides no information to allow the public to determine whether HedgeStreet's officers will be qualified to operate a futures exchange that "intends in the future to list hundreds of . . . contracts. . . ."¹²

The complete lack of futures experience—or even financial markets experience—is troubling, particularly at such a high level of the organization. Perhaps in recognition of this deficiency, HedgeStreet stated in 2001 that it would require that "at least *one* of the directors will be an individual who has expertise in futures trading or the regulation thereof. . . ."¹³ However, given the immense power of the board, which includes the ability to establish policy, make and amend rules and determine the contracts traded and margin requirements,¹⁴ the appointment of only one experienced director would be grossly insufficient.

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² 2001 Application at 1.

¹³ *Id.* at 53 (emphasis added).

¹⁴ *See* Rule 1.1; 2001 Application at 54.

Finally, the Application does not adequately set forth HedgeStreet's membership fitness standards, in violation of Core Principle 14.¹⁵ To become a Member of HedgeStreet, the Rules provide that a prospective member need only reside in the U.S., have a bank account in the U.S., make certain certifications and deposit \$500.00 into the HedgeStreet account.¹⁶ These standards are not sufficient. The Rules do not appear to apply any financial or disciplinary standards to the membership process, and they fail to set forth any standards for so-called "Authorized Representatives" of Members, who appear to have the same rights as Members to buy and sell contracts through HedgeStreet's website.¹⁷

Based upon the deficient ownership, organizational and management information that HedgeStreet has (or has not) provided to the public, the Commission should reserve consideration of the Application until HedgeStreet makes full disclosure of these important matters.

B. Market Surveillance and Other Self-Regulatory Activities.

1. Outsourcing to the NFA.

HedgeStreet proposes to shift its arbitration and compliance responsibilities to the NFA. According to HedgeStreet, however, as of September 22, 2003, HedgeStreet was still "working on an agreement with NFA."¹⁸ HedgeStreet is thus seeking contract market designation from the Commission even though it has not reached an agreement with the NFA. Moreover, to the extent that HedgeStreet and the NFA do reach an agreement, the NFA cannot provide services until the agreement is approved by the NFA's Board of Directors. The Application is thus not ripe for Commission determination.

Additionally, the Application does not explain how the NFA intends to carry out the compliance functions or how it will assure that the costs associated with these functions are not being borne by other industry participants, like the Exchange and other extant exchanges, which contribute significant funds to the NFA. Further, the Application makes no mention of whom or what will substitute for the NFA should it decline to provide the regulatory services. It is simply premature to publish an

¹⁵ Core Principle 14 provides that: "The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, *and any other persons with direct access to the facility* (including any parties affiliated with any of the persons described in this paragraph.")(emphasis added).

¹⁶ See Rule 2.1.

¹⁷ See Rule 2.4.

¹⁸ See Chart at C-4.

application for comment when an essential element of the public protection program is so uncertain.

2. Rule Deficiencies.

A fundamental precept under the Act is that exchanges enact and enforce comprehensive trade practice and market surveillance rules to ensure fair and equitable trading.¹⁹ Certain of HedgeStreet's Rules do not meet the high standards required by the Act. For example:

- In contravention of Core Principle 5 of the Act,²⁰ HedgeStreet "proposes not to have position limits," and then sets forth a litany of specious reasons that purport to justify the contravention. HedgeStreet's position, however, ignores that an unduly large futures position could encourage a market participant to attempt to manipulate the price of the underlying commodity. Thus, with respect to futures based upon the consumer price index, a market participant could attempt to interfere with the mechanics of the index construction or attempt to manipulate the prices of commodities in the index. While the likelihood of such a manipulation may be relatively low, the likelihood of manipulation in any listed futures contract is generally low, but the Act still requires position limits. Thus, despite HedgeStreet's protestations to the contrary, HedgeStreet should be required to comply with Core Principle 5 of the Act.
- With respect to HedgeStreet's market surveillance program, the Rules merely provide that HedgeStreet will run programs on data to "alert HedgeStreet when potentially unusual trading activity takes place."²¹ The Rules do not provide any specific guidance with respect to the type of data

¹⁹ See, e.g., Designation Criterion 3 of the Act provides, which provides, in part, that: "The board of trade shall establish and enforce trading rules to ensure fair and equitable trading through the facilities of the contract market, and the capacity to detect, investigate, and discipline any person that violates the rules."

²⁰ Core Principle 5 of the Act provides: "To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculator, where necessary or appropriate."

²¹ See Rule 7.1.

that HedgeStreet will analyze, who will analyze the data,²² or what constitutes “unusual trading activity.”²³

- Rule 3.13, which delineates prohibited transactions and activities, does not include a prohibition against market manipulation.

An application for designation must demonstrate that the applicant has enacted and can enforce fair and equitable trading through the facilities of the exchange and has the capacity to detect, investigate, and discipline any person that violates the Rules. HedgeStreet has failed to demonstrate such a capacity in its Application.

C. Clearing and Risk Management.

A clearing and settlement system requires logical, comprehensive, and detailed procedures. The Application, however, fails to spell out how many of these procedures will be performed. Rather, HedgeStreet relies upon a conclusory four-page section in the Chart, hoping to demonstrate compliance with the Core Principles concerning designated clearing organizations. Moreover, HedgeStreet devotes approximately one page to clearing-related matters in the Rules. As proposed, the Application does not satisfy the requirements of the Act. For example:

- HedgeStreet states that “[a]ll funds in Member accounts and in the HedgeStreet settlement account will be maintained in an account at the HedgeStreet settlement bank. . . .” Noteworthy is the lack of information of the identity of the bank; capacity of the bank to clear trades; the relationship, if any, between the bank and HedgeStreet (or Pareto); the bank’s capacity and procedures to conduct futures settlements; and whether the bank has received approval from the banking regulators to engage in this activity.
- Rule 5.1 provides that: “. . . HedgeStreet may adjust the terms of outstanding Contracts as it deems appropriate in its discretion to achieve fairness. . . . In addition, if the outcome of the event is unclear, HedgeStreet may, at its sole discretion, delay settlement until the outcome is clear to HedgeStreet. . . .” While giving itself virtually unbridled authority to adjust the terms of outstanding contracts, HedgeStreet fails to set forth any adjustment standards or describe the manner by which it will make adjustments to “achieve fairness to holders of Contracts.” Moreover, given that HedgeStreet will know which Members own what positions, HedgeStreet should be required to implement procedures to

²² While Rule 7.2 states that HedgeStreet will have a compliance department consisting of at least one compliance officer, the Application provides no information concerning the compliance officer’s experience or capacity to perform the functions required of him.

²³ See Rule 7.2.

ensure that any adjustment allocation does not favor one Member (or group of Members) at the expense of another Member (or group of Members).

D. Trade Execution Facility.

In addressing the trading system, the Application does not satisfy Designation Criterion 4 of the Act, which requires that an exchange:

. . . (A) establish and enforce rules defining, or specifications detailing, the manner of operation of the trade execution facility maintained by the board of trade, including rules or specifications describing the operation of any electronic matching platform; and (B) demonstrate that the trade execution facility operates in accordance with the rules or specifications.

HedgeStreet fails to set forth any specification with respect to the manner or operation of the trade execution facility. Rather, HedgeStreet makes opaque statements, such as:

HedgeStreet will demonstrate that the HedgeStreet system functions as described in the Application and HedgeStreet's Rules. ECS has already received prior approval from the commission and it has been demonstrated that the trade execution facility satisfies these requirements.²⁴

HedgeStreet's explanation is both speculative and vague. HedgeStreet's statement that it "will demonstrate that the HedgeStreet system functions as described in the Application and HedgeStreet's Rules" means that the Application is premature with respect to one of the most basic aspects of the operation of the proposed exchange. At the same time, the Application lacks the detail and comprehensiveness that Designation Criterion 4 of the Act requires, and which the Commission has required of other designated contract markets.

Conclusion

We believe that it is apparent from the partial list of shortcomings and deficiencies discussed above that the HedgeStreet proposal is materially incomplete in addressing every major function of a contract market. Furthermore, the few features for which detailed information is available appear to raise substantial customer protection, financial, and operations deficiencies. We urge the Commission to disapprove the proposal as filed. In addition, the filing is so deficient in material respects that it cannot possibly be considered by the Commission in its present form. At a minimum, HedgeStreet should be required to supplement or amend the filing to fill in the gaping holes and commentators should be given another opportunity to submit comments.

²⁴

Chart at C-2.

Ms. Jean Webb
October 14, 2003
Page 9

If you have any questions or comments, please do not hesitate to contact me, Matthew F. Kluchenek, Director and Associate General Counsel, at (312) 338-2861, or Jerry Salzman, at (312) 222-5131.

Respectfully submitted,



Craig S. Donohue

CSD/MK/6415.ltr