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January 5, 2006

VIA EMAIL: [secretary@cftc.gov](mailto:secretary@cftc.gov)

Ms. Jean A. Webb  
Secretary of the Commission  
Commodity Futures Trading Commission  
3 Lafayette Centre  
1155 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20581

**RE: Rule Certification: HedgeStreet Market Maker Subsidiary Pilot Program**

Dear Secretary Webb:

Pursuant to Section 5c(c)(1) of the Commodity Exchange Act, as amended ("Act") and §40.6 of the Regulation promulgated by the Commodity Futures Trading Commission (the "Commission") under the Act, HedgeStreet, Inc. ("HedgeStreet") hereby submits to the Commission the terms and conditions for the HedgeStreet Market Maker Subsidiary Pilot Program ("Program"). HedgeStreet will launch the Program for a period of six (6) months to commence on January 6, 2006 until June 30, 2006 in order to promote seed liquidity on the Market.

HedgeStreet describes in Exhibit 1 the structure and controls in place at both HedgeStreet and the Subsidiary in order to ensure that there is adequate separation between the two entities and that the trading activities of the Subsidiary are objectively reviewed and investigated. Exhibit 2 gives an example of certain qualifying questions that are currently posed to both member applicants and their authorized traders during the membership application process that must be truthfully answered in order for such market participants to have access to the HedgeStreet Market. The Subsidiary's Authorized Trader(s) will also be required to answer all of the qualifying questions contained in Exhibit 2 and HedgeStreet will be responsible for ensuring the accuracy of the responses in a similar fashion to the way HedgeStreet conducts background checks on all member applicants and their authorized traders.

In addition to the above referenced Exhibits contained in this submission, HedgeStreet has filed concurrently with this submission to the Commission the following Appendices:

- Appendix 1 – Financial Considerations and Risk Management Plan
- Appendix 2 – HedgeStreet Policy Statement on the Use and Disclosure of Material, Non-Public Information
- Appendix 3 – Organizational Chart

Please be advised that Appendices 1 – 3 contain trade secrets or confidential commercial or financial information of HedgeStreet. Therefore, on January 5, 2006, simultaneously with this submission, HedgeStreet petitioned for confidential treatment to be afforded to the aforementioned



appendices pursuant to Commission Regulation §145.9 until HedgeStreet notifies the Commission that HedgeStreet, Inc., no longer regards such information as confidential.

HedgeStreet intends that the Subsidiary will commence trading activities on January 6, 2006.

No substantive opposing views were expressed to HedgeStreet with respect to this Program.

Should you have any questions regarding this submission, please do not hesitate to contact Stephanie Ford by telephone at (650) 638-3511 or by email at [sford@hedgestreet.com](mailto:sford@hedgestreet.com).

Sincerely,

Stephanie Ford  
Vice President of Legal & Compliance

cc: Thomas Leahy – CFTC  
Phil Colling – CFTC  
Riva Adriance – CFTC  
Clarissa Manansala – HedgeStreet, Inc.



## EXHIBIT 1

### Details of the Subsidiary

#### 1. Introduction

HedgeStreet is a registered derivatives clearing organization (“DCO”) and designated as a contract market (“DCM”) with the Commodity Futures Trading Commission (“Commission”). In order to promote seed liquidity on its market, HedgeStreet has developed this Program in order to establish a wholly-owned market maker subsidiary (“Subsidiary”) that will provide liquidity for all of the contract types listed in Section 8b available for trading on the HedgeStreet non-intermediated market (“Retail Market”) <sup>1</sup>. The Subsidiary will be required to abide by the same rules and policies as any other market maker of HedgeStreet. In addition, since the Subsidiary will be wholly-owned by HedgeStreet, HedgeStreet understands that certain risk management and operational controls need to be implemented in order to maintain a fair and orderly marketplace. A description of the structure of the Subsidiary and the risk management controls that will be implemented are described in further detail below.

#### 2. Creation Of Subsidiary as a Market Maker of HedgeStreet

HedgeStreet is a fully electronic non-intermediated market that allows individuals and entities to become exchange members and directly trade on HedgeStreet. Any person or entity that is interested in becoming a member of HedgeStreet is required to complete an on-line membership application which is reviewed by HedgeStreet. During the membership application process, all applicants are required to answer certain qualifying questions (“Questions”) relating to an applicant’s disciplinary and criminal history. (A sample of the Questions used by HedgeStreet is contained in Exhibit 2). If an entity, such as a corporation or partnership, chooses to establish an account with HedgeStreet, that entity applicant is also required to complete an additional certification document signed by authorized parties of the entity applicant in order to, among other things, i) ensure that the party completing the membership application on behalf of the entity applicant is authorized to do so, ii) obtain the identity of all Authorized Traders that will enter transactions on the market on behalf of the entity applicant, and iii) require that all Authorized Traders complete all Questions. For purposes of this submission, the term “Authorized Trader” is synonymous with the term Market Maker Representative currently defined in HedgeStreet Rule 4.2.

Once a member applicant has successfully completed the membership application and funded an account, HedgeStreet conducts a criminal and disciplinary background check pursuant to an agreement with McDonald Information Services (“MIS”). MIS confirms that the member or its

<sup>1</sup> During initial discussions with Commission staff regarding the trading practices of the Subsidiary, HedgeStreet represented that all contracts traded by the Subsidiary will be traded on the Retail Market cleared by HedgeStreet in its capacity as a DCO and therefore, fully collateralized pursuant to the Commission’s Amended Order of Registration for HedgeStreet as a DCO dated December 1, 2004. HedgeStreet will inform Commission staff in a timely fashion prior to certification by HedgeStreet pursuant to Regulation §40.6 if HedgeStreet has any intent to materially change this representation.



Authorized Trader accurately responded to the Questions by conducting a criminal and disciplinary background check on such member and its Authorized Traders.

The Subsidiary, which will be an entity member of HedgeStreet, will be required to engage in the same membership application processes outlined above, including background checks on all Authorized Traders that will be entering transactions on behalf of the Subsidiary. If any Authorized Trader of the Subsidiary answers affirmatively to any of the membership qualifying questions, HedgeStreet would investigate further by requesting additional information from the Authorized Trader as well as engage in additional due diligence efforts as necessary. All employees/consultants of the Subsidiary will also be subject to background checks as a condition of employment.

### **3. Structure of Subsidiary**

The Subsidiary will be established as a Delaware corporation called Tower 3 Capital, Inc. The Subsidiary will have an initial Board of Directors that will be comprised of one board member that is also a member of the HedgeStreet board. The Subsidiary will initially have two employees that will act as the authorized traders ("Authorized Traders") for the Subsidiary. In addition, HedgeStreet will create a Market Maker Oversight Committee that will be responsible for monitoring the day to day activities of the Subsidiary.

#### *a. Operation of Subsidiary*

The Subsidiary will be a completely separate entity from HedgeStreet, Inc. The Subsidiary will maintain separate bank accounts from any HedgeStreet accounts. In addition, the Subsidiary will not be permitted to incur any debt including for trading purposes other than operating liabilities in the normal course of business.

The Subsidiary will issue a separate financial statement but the entity will be included in HedgeStreet, Inc.'s combined audited financial statements. HedgeStreet will guarantee all of the financial liabilities of the Subsidiary. Since all transactions executed by the Subsidiary are fully collateralized in cash prior to trade execution, there will be no outstanding obligations on any contract. All financial statements for the Subsidiary will be prepared by HedgeStreet staff.

Finally, all employees/consultants of the Subsidiary will be subject to the same fitness standards as HedgeStreet employees, including, but not limited to, regulatory and criminal background checks.

#### *b. Authorized Traders*

All members and their Authorized Traders are required to abide by all of the rules and policies of HedgeStreet. For example, all members and their Authorized Traders are precluded from trading more than one HedgeStreet account pursuant to Rule 3.1(f). In addition, pursuant to Rule 5.13(a), members and their Authorized Traders are prohibited from entering orders on the Market if there are insufficient funds or Contracts in their account to satisfy such orders if they are executed. Any Authorized Trader of the Subsidiary will be subject to the same restrictions as any other member or



Authorized Trader, including, but not limited to, Rule 3.1(f) and Rule 5.13(a) described in the preceding sentences. Authorized Traders for the Subsidiary will not be current employees of HedgeStreet.

*c. Market Maker Oversight Committee*

Initially, the Market Maker Oversight Committee ("Committee") will be comprised of three members: the Vice President of Legal and Compliance, the Vice President of Instrument Origination and the Director of Finance of HedgeStreet, Inc and will be responsible for the daily oversight of the activities of the Subsidiary. The Committee will review the day to day activities of the Subsidiary to monitor the monetary triggers identified in Appendix 1 as well as monitor the over all activity in HedgeStreet's capacity as a self-regulatory organization.

**4. Oversight**

*a. Risk Management Plan*

HedgeStreet will implement a risk management and operational plan ("Risk Management Plan") for the Subsidiary which implements controls over the trading activity of the Authorized Trader(s). Since all contracts that trade on the Retail Market are fully collateralized prior to trade execution, there will be a limit on the amount of risk exposure endured by the Subsidiary, including, but not limited to, counterparty risk. However, HedgeStreet will impose the limitations and conditions on the trading activities of the Subsidiary stipulated in Appendix 1.

*b. Risk Management Controls*

In order to ensure that the Risk Management Plan is adhered to, HedgeStreet has developed risk management controls to monitor the activities of the Subsidiary and its employees. These controls are either in conformity with or more stringent than the HedgeStreet market making rules. The following is a list of the controls and a brief explanation of the function of each.

- *Committee*

HedgeStreet will establish the Committee which will initially be comprised of three HedgeStreet employees. This Committee will have the following responsibilities:

- Discuss unusual trading activity with the Authorized Traders and investigate further if necessary;
- Establish and maintain trading limits, internal controls and risk management safeguards;
- Halt trading operations of the Subsidiary or order liquidation of the Subsidiary's market maker positions at any time;
- Periodically report to HedgeStreet's Board of Directors regarding the Subsidiary.

- *National Futures Association*



HedgeStreet entered into a Regulatory Services Agreement (“RSA”) with the National Futures Association (“NFA”). Pursuant to the RSA, NFA shall review HedgeStreet’s traders (e.g. members and Authorized Traders) on a routine basis to determine whether suspicious activity relating to HedgeStreet’s trading standards exists. Since market makers are members of HedgeStreet, NFA does monitor for suspicious trading activity conducted by such members pursuant to the RSA. In order to assist NFA in this review process, HedgeStreet provides NFA a monthly spreadsheet indicating certain identifying information of all of the HedgeStreet market makers. The spreadsheet information includes certain identifying information such as the name and address of the market maker, User ID and the primary markets that are traded by the market maker. HedgeStreet will provide the same identifying information to NFA for the Market Maker Subsidiary. In addition, in accordance with the RSA, NFA informs HedgeStreet of potential irregularities relating to the services described in the RSA. HedgeStreet therefore anticipates that NFA will objectively review the trading activities of the Subsidiary in the same way that it currently does for all other members and market makers of HedgeStreet.

- *Notification to CFTC*

As represented above, NFA informs HedgeStreet of potential irregularities that occur on the HedgeStreet market in accordance with the terms of the RSA. However, HedgeStreet acknowledges that potential conflicts of interest may arise if NFA informs HedgeStreet that the Subsidiary appears to be trading or engaging in activity that is irregular or suspicious. Therefore, HedgeStreet has agreed with Commission staff that if NFA or HedgeStreet believe that the Subsidiary is engaging in potentially questionable activity, HedgeStreet will notify the appropriate Commission staff within a reasonable amount of time after HedgeStreet is notified or made aware of such Subsidiary activity.

**5. Disclosure Issues**

In order to ensure that HedgeStreet members are aware that a subsidiary of HedgeStreet will be acting as a market maker for certain contracts, HedgeStreet will inform all members about the Subsidiary and its relationship to HedgeStreet on its website.

**6. Conflicts of Interest**

HedgeStreet acknowledges that there may be potential conflicts of interests inherent in the establishment and operation of a market maker subsidiary that is wholly-owned by HedgeStreet. Therefore, HedgeStreet has implemented certain restrictions on the activities of the employees of the Subsidiary as well as employees of HedgeStreet.

a. *Chinese Wall*



Most HedgeStreet contracts have an Expiration Value<sup>2</sup> that is based upon public data which the exchange does not have access to until it is publicly released by the Source Agency<sup>3</sup> (e.g. contracts that are based on the value of the Federal Funds Rate, Consumer Price Index, etc.). However, HedgeStreet will restrict the information flow to the Subsidiary from the exchange. The employees of the Subsidiary will not have access to any HedgeStreet material, non-public information<sup>4</sup>. All files and documents containing such material, non-public information will be maintained in either locked file cabinets in the HedgeStreet corporate offices or located on a password protected computer system not accessible to any Subsidiary employee or consultant. HedgeStreet also restricts the flow of such information by implementing an exchange policy which precludes HedgeStreet employees/consultants from distributing any material non-public information to the employees/consultants of the Subsidiary or any other third party. This policy is contained in Appendix 2 and has been implemented as of the date of this submission. If a HedgeStreet employee/consultant violates this policy, he/she may be subject to suspension and or termination. Additional controls include;

- Subsidiary employees/consultants will be located in a segregated walled off office<sup>5</sup> within the HedgeStreet Corporate Offices.
- Subsidiary employees/consultants will not have access to HedgeStreet Inc.'s internal computer network.
- Subsidiary employees/consultants will not have access to HedgeStreet, Inc. files or records.

b. *Trading Activities of Subsidiary employees/consultants:*

Authorized Traders of the Subsidiary will be subject to the same trading restriction as other members of HedgeStreet as well as be subject to an internal policy imposed by the Committee. HedgeStreet Rule 3.1(f) precludes Authorized Traders of any entity member from trading or maintaining more than one HedgeStreet account. In addition, all employees or consultants of the Subsidiary will be required to abide by a policy that precludes such employees and consultants from trading for any account other than an account for the benefit of the Subsidiary.

c. *Non-Public Information*

In accordance with Commission Regulation 1.59(d)(ii) and HedgeStreet Rule 11.1(d), no HedgeStreet board member, committee member or employee or consultant is permitted to disclose material non-public information to any person, including, but not limited to members of HedgeStreet. In addition, HedgeStreet has an internal policy, which is contained in Appendix 2, which reinforces Commission Regulation 1.59 and HedgeStreet Rule 11.1(d) by precluding any

<sup>2</sup> "Expiration Value" is defined in HedgeStreet Rule 1.1(f) as the rate, level, amount, measure, or other value of the Underlying at Expiration.

<sup>3</sup> "Source Agency" is defined in HedgeStreet Rule 1.1(w) as the agency that publishes the Underlying economic indicator and/or Expiration Value for any Hedgelet Contract.

<sup>4</sup> "Material, Non-Public Information" has the same meaning as defined in Commission Regulation §1.59(a).

<sup>5</sup> A "walled off office" means an office with a door that only employees of the Subsidiary will occupy in the HedgeStreet corporate office building.



improper use or dissemination of material non-public information by any HedgeStreet board member, employee or consultant.

## 7. Rule Enforcement

As with all other HedgeStreet members and market makers, the Subsidiary and its Authorized Traders will be subject to exchange disciplinary and arbitration processes. In addition, HedgeStreet intends to work with NFA in the same manner as it currently does with respect to the trading activities of all members of HedgeStreet in accordance with the RSA, including, but not limited to, a review of the trading activities of market makers as members of HedgeStreet. Finally, the Subsidiary will be subject to the Commission's Rule Enforcement Review process.

## 8. Trading

### a. *Bid-Ask Spread and Trade Size*

HedgeStreet has a general market maker agreement that defines the bid/ask spread and trade size market makers are required to maintain during such times as defined in the agreement. In order for the Subsidiary to be designated as a market maker of HedgeStreet, HedgeStreet will require the Authorized Traders of the Subsidiary to complete the same standard market maker agreement that every other market maker of HedgeStreet completes. The spreads and trade sizes will be detailed in the market maker agreement. The Subsidiary will not receive any preferential treatment from HedgeStreet and the Subsidiary will be required to abide by all of the same trading rules and policies that other members and market makers are required to follow as market participants of HedgeStreet.

### b. *Designated Contracts*<sup>6</sup>

The Subsidiary must maintain a continuous two-sided spread for no less than 75% of the time the specific Designated Contract is open for trading. The Designated Contracts, the applicable maximum spread and minimum size are defined in the chart below.

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<sup>6</sup> Designated Classes" are those Classes of contracts in which a market maker has been appointed to abide by all of the market maker obligations defined in HedgeStreet Rule 4.5 as well as the respective market maker agreement.





<b>Designated Contract Type</b>	<b>Maximum Spread</b>	<b>Minimum Size</b>
Non-Farm Payrolls	10%	10
Inflation	10%	10
Currencies	10%	10
Commodities	10%	10
Economic Derivatives	10%	10
Real Estate	10%	10
Mortgages	10%	10
Energy	10%	10
Interest Rate	10%	10

In return for making markets in such Designated Classes, the Subsidiary will not pay any trading or settlement fees for the duration of the Program.

*c. Guidelines*

As with all other HedgeStreet market maker agreements and except for the information provided herein, the details of that agreement will not be disclosed to market participants.

All market positions of the Subsidiary will be carried on the books of HedgeStreet in its capacity as a DCO.

**9. Registration**

The HedgeStreet Retail Market currently precludes intermediation by any member or market maker. Therefore, the Subsidiary does not need to be registered in any capacity with the Commission or NFA since HedgeStreet Rules only allow Members to trade for their own account or the account for which a person acts as an Authorized Trader.

Entity members of HedgeStreet may have more than one Authorized Trader trading on its behalf. Such entity members may prefer that each Authorized Trader maintain a separate sub-trading account in order to keep detailed records of each Authorized Trader's profit and loss and trading activities since such Authorized Traders are all trading for the benefit of the entity member and not for their personal accounts. Therefore, one entity member may have a separate "sub-account" for each Authorized Trader. Each Authorized Trader may only maintain or trade one HedgeStreet account in accordance with HedgeStreet Rule 3.1(f). Initially, the Subsidiary will have two Authorized Traders each trading one sub-account of the Subsidiary totaling two sub-accounts. If the Subsidiary hires additional Authorized Traders, the Subsidiary may choose to establish additional sub-accounts for each Authorized Trader similar to the manner in which other market makers manage their Authorized Traders on HedgeStreet.

**10. Employee Fitness**



As stated in Section 3a, all employees/consultants of the Subsidiary will be subject to criminal and disciplinary background checks as a condition of employment. As Authorized Traders of entity members of HedgeStreet, HedgeStreet conducts additional checks to ensure adequate fitness standards of members and their Authorized Traders trading on such member's behalf. First, HedgeStreet asks the Questions contained in Exhibit 2 during the membership application process of every candidate that is applying to become an authorized trader of HedgeStreet. HedgeStreet reviews the responses to such questions on a regular basis to ascertain whether any applicant has answered the Questions affirmatively. Then, HedgeStreet will conduct a separate regulatory background check as it does with all other authorized traders of a member/market maker pursuant to a contract with MIS which allows HedgeStreet, among other things, to confirm whether the applicant answered the Questions truthfully. The results of the background checks conducted by MIS will be maintained in a separate HedgeStreet database at MIS. MIS notifies HedgeStreet via email of any negative disciplinary, regulatory, criminal or civil information that has arisen or that may arise regarding a potential member or authorized trader after the authorization to trade on HedgeStreet has been granted.

HedgeStreet represents that the Subsidiary will not knowingly employ any Authorized Traders who are subject to statutory disqualification under Section 8a(2) of the Act. In addition, HedgeStreet represents that it will not knowingly employ any Authorized Traders who were subject to a statutory disqualification under section 8a(3) of the Act without first seeking a waiver from the Commission.

#### **11. Books and Records**

Pursuant to HedgeStreet Rule 3.2(a), any member, including market makers, must cooperate promptly and fully with HedgeStreet, its agents, and/or the Commission in any investigation, call for information, inquiry, audit, examination, or proceeding. In addition, pursuant to HedgeStreet Rule 3.2(b), the Subsidiary is required to provide all information HedgeStreet has about it, including its trading activity, to the Commission or any other regulatory or self-regulatory body, law enforcement authority, or judicial tribunal, including (as may be required by information sharing agreements or other contractual, regulatory, or legal provisions) foreign regulatory or self-regulatory bodies, law enforcement authorities, or judicial tribunals. Therefore, the Subsidiary, as with other members of HedgeStreet, will be required to make accessible its books and records to the CFTC from both an operational and financial perspective.



## EXHIBIT 2

### Member Qualifying Questions

1. Have you had trading privileges suspended by, been denied access to, or been denied membership in, any commodity or security exchange or association?  
Y\_\_\_ N\_\_\_
  
2. Have you been convicted of, pled guilty to, or entered a plea of no contest or plea agreement to, any felony in any domestic, foreign, or military court?  
Y\_\_\_ N\_\_\_
  
3. Have you been convicted of, pled guilty to, or entered a plea of no contest or plea agreement to, a misdemeanor in any domestic, foreign, or military court which involves:
  - Embezzlement, theft, extortion, fraud, fraudulent conversion, forgery, counterfeiting, false pretenses, bribery, gambling, racketeering, or misappropriation of funds, securities, or property?  
Y\_\_\_ N\_\_\_
  
  - Any transaction in or advice concerning futures, options on futures, leverage transactions, or securities?  
Y\_\_\_ N\_\_\_
  
4. Have you been subject to, or associated with a firm that was subject to, regulatory proceedings before any governmental or regulatory body?  
Y\_\_\_ N\_\_\_
  
5. Are you currently party to any actions, or is there a charge pending, the resolution of which could result in a Yes answer to questions 1 through 4 listed above?  
Y\_\_\_ N\_\_\_