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20 South Wacker Drive 312/930.8275 tel
Chicago, IL 60606-7499 312/930.3209 fax
www.cme.com RECORDS SECTION

Craig S. Donohue
Chief Executive Officer

July 24, 2006

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Ms. Eileen Donovan
Acting Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

COMMENT

Re: Boards of Trade Located Outside of the United States and the Requirement to Become a Designated Contract Market or Derivatives Transaction Execution Facility; 71 Fed. Reg. 113 (June 13, 2006)

Dear Ms. Donovan:

The Chicago Mercantile Exchange Inc. ("CME") welcomes the opportunity to provide its views to the Commodity Futures Trading Commission ("Commission" or "CFTC") respecting the appropriate treatment of foreign boards of trades ("FBOTs").

CME is currently the largest and most diverse financial exchange in the United States and the largest derivatives clearing organization in the world. As an international marketplace, CME brings together buyers and sellers on its CME Globex® electronic trading platform and trading floors. CME offers futures and options on futures primarily in five product areas: interest rates, stock indexes, foreign exchange, commodities and alternative investments. As a pioneer in the globalization of the futures markets, CME has helped to expand the customer base for futures products beyond traditional boundaries. CME Globex, for example, is available to users around the world for more than 23 hours a day and five days a week. To satisfy the increasing demands of the international marketplace, customers can access the Globex platform through more than 1,000 direct connections in more than 80 countries and foreign territories around the world. Telecommunications hubs in Singapore, London, Amsterdam, Dublin, Gibraltar, Milan and Paris reduce our customers' connectivity costs, increase accessibility, and delivery faster, more efficient trading. Additionally, CME has established offices in London, Sydney, Tokyo and Hong Kong. CME believes that its significant global expertise and experience will provide the Commission with a unique and valuable perspective on the matters discussed herein.

At the outset, it is important to note that, in our view, reducing or limiting barriers to entry in the global futures and options industry has strongly contributed to business growth and increased competition. For example, the compounded annual growth rate of the global futures and options industry from 2000 through 2005 was 22% compared to only 4% for equity securities markets. This is due, at least in part, to the fact that U.S. investors can directly and electronically trade foreign futures and options contracts from the U.S. Correspondingly, European and Asian investors can directly and electronically trade products listed by CME and other U.S. futures and options exchanges. Moreover, FBOTs can efficiently offer U.S. customers access to products also traded on U.S. exchanges, thereby increasing global competition in these markets. In contrast, under current SEC rules, U.S. investors cannot directly and electronically trade foreign equity securities of foreign issuers that do not comply with SEC disclosure standards or U.S. GAAP accounting standards. The CFTC has wisely promoted global growth and competition while recognizing that comparability in regulatory standards is superior to insisting upon additional, but not necessarily better, regulatory requirements.

REQUEST FOR COMMENT

The Commission's June 9, 2006, "Request for Comment" states that: "the Commission wishes to address the point at which an FBOT that makes its products available for trading in the U.S. by permitting direct access to its electronic trading system from the U.S. (direct access) is no longer 'located outside the U.S.' for purposes of section 4(a) of the Commodity Exchange Act (Act)." The Commission's Request for Comment presents two distinct questions. First, what is the Commission's authority under the Act? Second, how should the Commission exercise that authority to most effectively carry out its mandate in this era of electronic trading in global markets?

BACKGROUND

In 1998 and 1999, most U.S. exchanges encouraged the Commission to carefully control access by foreign boards of trade to U.S. customers and markets. At that time, U.S. exchanges had experienced significant obstacles to placing trading terminals in a number of foreign jurisdictions. Also, prior to the Commodity Futures Modernization Act of 2000 ("CFMA"), it made sense for U.S. exchanges to seek the protection of the Commission against foreign competitors operating under less burdensome and more flexible regulatory regimes. Before CFMA, U.S. exchanges had to seek approval of every new contract and every significant rule. It was nearly impossible for U.S. exchanges to compete effectively with FBOTs whose regulators imposed performance standards rather than prescriptive standards. CFMA greatly improved the competitive environment in the U.S. and eliminated many of the legitimate concerns of U.S. based futures exchanges.

Overall, we believe that the Commission has recognized the significant regulatory and competitive consequences of the migration from localized physical exchanges to global electronic exchanges. However, we are concerned that the Request for Comment will be viewed as a reversal of the positive trend that began with CFMA and which is embodied in the clear policy declarations of the present and immediately past chairmen.[1] CME believes that the

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[1] Address by Chairman Reuben Jeffery, III, *Global Derivates Markets: Challenges For Regulators And Exchanges*, before the Futures Industry Association, Japan Chapter, Tokyo, Japan (January 17, 2006); Remarks of James E. Newsome, Acting Chairman, *The Challenge Of Cross-Border Markets, Strengthening Regulatory Cooperation*, Before the European Financial Markets Convention, Paris, France (June 15, 2001).

Commission should continue to exercise its leadership to further harmonize international regulatory standards and ease limits on cross-border trading. Rather than limiting access or imposing restrictions on foreign exchanges, CME believes the Commission should eliminate antiquated or unnecessary regulary requirements imposed on U.S. markets that are competing against FBOTs offering the same product to the same customers.

COMMISSION'S AUTHORITY

Section 4(a) permits the offer or sale of futures contracts of foreign boards of trade to U.S. persons, if the exchange is located outside the U.S. If an exchange lost its character as "outside the U.S." by offering its contracts to U.S. persons, Section 4 (a) would be nugatory. Congress did not limit the exclusion to exchanges that had no contacts with the U.S. or had no offices or facilities in the U.S.: it created an exclusion for exchanges that were "located outside the U.S." We do not believe that the statutory language permits the Commission to declare that an exchange with some local connection, or that trades U.S. products, or that impacts U.S. markets loses its character as being located outside the U.S. so long as its core operations are "located outside the U.S." The location of an exchange may not be obvious if its operations are widely enough dispersed.

The Request for Comment also suggests a number of other factors, many of which have no locational nexus, that may be considered to determine whether a market is located outside the U.S. This approach confuses the Commission's perceived enforcement and regulatory needs with its statutory authority. The Commission staff's consideration of the following factors bears no relationship to the question of whether the market is located outside the U.S.: "(i) membership criteria (including financial requirements); (ii) various aspects of the automated trading system (including the order-matching system, the audit trail, response time, reliability, security, and, of particular importance, adherence to the IOSCO principles for screen-based trading); (iii) settlement and clearing (including financial requirements and default procedures); (iv) the regulatory regime governing the FBOT in its home jurisdiction; (v) the FBOT's status in its home jurisdiction and its rules and enforcement thereof (including market surveillance and trade practice surveillance); and (vi) extant information-sharing agreements among the Commission, the FBOT, and the FBOT's regulatory authority." Reference to such factors to deny access is tantamount to regulating the foreign board of trade and is not consistent with the Act.

Section 4(a) applies to the business done by an exchange located outside the U.S. with customers in the U.S. The exclusion is not conditioned on the quality of foreign regulation, the nature of the contract, the nature of the U.S. customer or the comparative volume of trading originating in the U.S. The language of the statute is unambiguous. It is improper for the Commission to ignore the statute because of its perceived regulatory imperative. This principle was forcefully applied by the United States Court of Appeals for the District of Columbia Circuit overturning the SEC's construction of the term "client" in the Investment Advisers Act of 1940. *Goldstein v. Securities and Exchange Commission*, 2006 WL 1715766 (D.C. Cir. June 23, 2006). The court held that "[a]n agency construction of a statute cannot survive judicial review if a contested regulation reflects an action that exceeds the agency's authority. It does not matter whether the unlawful action arises because the disputed regulation defies the plain language of a statute or because the agency's construction is utterly unreasonable and thus impermissible." *Id.* at *7 (quoting *Aid Ass'n for Lutherans v. United States Postal Serv.*, 321 F.3d 1166, 1174

(D.C. Cir. 2003)). The court added that "[t]he 'reasonableness' of an agency's construction depends," in part, "on the construction's 'fit' with the statutory language, as well as its conformity to statutory purposes." *Goldstein,* 2006 WL 1715766, at *7 (quoting *Abbott Labs., v. Young,* 920 F.2d 984, 988 (D.C. Cir. 1990)). The fact that there may have been a clear regulatory imperative for demanding that certain hedge fund advisers register was deemed irrelevant:

> "That the Commission wanted a hook on which to hang more comprehensive regulation of hedge funds may be understandable. But the Commission may not accomplish its objective by a manipulation of meaning." *Goldstein, supra,* at *8.

Section 4(a) more narrowly circumscribes CFTC's authority to define what constitutes an FBOT than is suggested by the Request for Comment. The statute says that it is legal to sell futures in the U.S. if they are "made on or subject to the rules of a board of trade, exchange, or market located outside of the United States . . . ." Nothing in the statute requires that the board of trade, exchange, or market be regulated or run in any particular fashion. Nothing even requires that the board of trade, exchange, or market be organized in any traditional form. The CFTC's ability to protect U.S. customers in respect of trading on such markets is preserved by subsection (b), which also includes limitations based on the location of the intermediary. Section 4(b) restricts the Commission's authority to "any person <u>located in the United States</u>, its territories or possessions, who engages in the offer or sale of any contract of sale of a commodity for future delivery that is made or to be made on or subject to the rules of a board of trade, exchange, or market located outside the United States, its territories or possessions." (emphasis added) The Commission's power under Section 4(b) to regulate persons located in the U.S. who offer futures contracts clearly does not extend to the foreign board of trade on which the contract is listed.

The legislative history confirms the plain meaning of the text in Section 4. Section 4(b) was added in 1982 concerning the Commission's "existing authority to regulate the offer and sale of futures contracts made on foreign exchanges by *any person* located *in* the United States, its territories or possessions." H.R. Rep. No. 97-565, Part I, at 85 (1982), *reprinted in* 1982 U.S.C.C.A.N. 3871, 3934 (emphasis added). In explaining the scope of the Commission's authority, the House of Representatives Report explained that while the Commission has the power in Section 4(b) to regulate "a *vendor* of foreign futures who is located in the United States," the statute "does not authorize the Commission to regulate the internal affairs of a foreign board of trade, exchange, market, or clearinghouse for such market (such as the terms and conditions of foreign futures created by a foreign exchange) or require Commission approval of any action of any such market or its clearinghouse." *Id.* (emphasis added).

Similarly, the Senate Report on the 1982 legislation confirms that Section 4(b) was narrowly circumscribed to authorize the Commission only "to promulgate regulations relating to fraud, minimum financial standards, disclosure of risk and reporting requirements, keeping of books and records, safeguarding of customer funds and registration of *any person located in the United States* who is engaged in the offer and sale of foreign futures contracts." S. Rep. No. 384, 97th Sess., 2d Part, at 3 (1982) (emphasis added). Because of the growth in foreign futures contracts (*id.* at 16), Congress saw fit to add Section 4(b) "to provide adequate protection for American residents who are solicited to trade foreign futures contracts by vendors *within the United States . . . .*" *Id.* at 46 (emphasis added). But the Senate Report, upon which the Commission has mistakenly relied to support its claim for sweeping powers to regulate foreign exchanges, expressly cautioned that those powers were limited: "However, the Commission's authority to adopt rules and regulations under this section does not include authority to approve the contracts, contract terms, rules, or actions of a foreign board of trade, market, or clearinghouse." *Id.* at 46; *see also id.* at 3. Moreover, the "Commission's authority to adopt rules and regulations under this provision [was] not intended to impair the contractual duties, obligations, or rights arising from the rules or practices of any foreign board of trade, market, or clearinghouse or the principals of any such entities." *Id.* at 46. Congress noted that the Commission already had authority to regulate such fraudulent trades and had promulgated a rule prohibiting fraud in the offer and sale of foreign futures contracts within the United States. *Id.* at 45. Congress further directed that it did not intend "to place the solicitation or acceptance of orders in the United States for bona fide foreign futures contracts at a comparative disadvantage with similar solicitation" of customer funds in the United States. *Id.* at 46.

The Request for Comment relies in part on the Commission's Concept Release published on July 24, 1998, which sought public comment on the use in the United States of automated trading systems to provide access to electronic boards of trade operating outside the United States. The Commission's reliance on the description of the legislative history regarding the Commission's jurisdiction to regulate foreign exchanges is, however, misguided. The Concept Release suggests that when Congress precluded the Commission from regulating exchanges "located outside the United States," Congress somehow meant only to exclude "'bona fide foreign futures contracts' traded in a regulated exchange environment." Request for Comment, p. 8 n.15. But the legislative history cited contains no support for that view. Instead, Congress stated that the Commission may not "regulate the internal affairs of a foreign board of trade, exchange, market, or clearinghouse . . . ." H.R. Rep. No. 565, Part I, 85 (1982), *reprinted in* 1982 U.S.C.C.A.N. 3871, 3934; *see also* S. Rep. No. 384, 97th Cong., 2d Part (1982), at 46. Nowhere did Congress carve out or distinguish any exception for a "bona fide" foreign exchange or "bona fide foreign futures" contracts traded on a foreign exchange.

Of course, Sections 4(a) and (b) were drafted in 1982, when most exchanges were limited to physical trading facilities, limited trading hours and closed-access business models. It was before the internet was available to every trader, before ISVs and intermediaries took over the role of providing trading front ends, and before markets were truly global. Section 4(a) was drafted with the expectation that the location of a market could be easily identified. In 1982, location was well understood to mean a single jurisdiction-the headquarters of the exchange that housed its trading floor. Maintenance of remote sales offices and communication networks did not inject ambiguity into the definition of "location." Congress clearly anticipated the offer and sale of foreign futures to U.S. customers, while precluding Commission control of the terms and conditions of the contracts being offered by those foreign boards of trade. Section 4(b) was drafted to protect U.S. customers by controlling the intermediaries. Of course Congress expected that there would be some sort of U.S. based intermediary between U.S. customers and the foreign markets.

Advances in the industry have challenged the usefulness of the statute and may have encouraged the Commission to go beyond the permissible bounds of statutory interpretation in order to fulfill its understanding of its responsibilities under the Act. In the beginning of the electronic exchange era, foreign exchanges used dedicated networks and terminals to extend their access to the U.S. Suggestions were made by Commission staff that placing such terminals in the U.S. meant that the exchange was no longer located outside the U.S. While there was no authority for this interpretation, uncertainty regarding the CFTC's position and unwillingness to fight when the matter could be resolved by a relatively inexpensive no-action letter gave the Commission staff some control without regard to the limitations imposed on the Commission by the statute.

Advances in electronic trading have made the dedicated terminal argument that was advanced in support of the need for no-action relief untenable. Now foreign markets can be reached via the internet or thought the facilities of independent software providers. It is not clear that the Commission's strategy of regulating access to foreign exchanges has any legitimate basis. If access is by means of an internet connection, there is no U.S. person who "engages in the offer or sale of any contract of sale of a commodity for future delivery that is made or to be made on or subject to the rules of a board of trade, exchange, or market located outside the United States . . . ." Second, even if access is via an ISV provided front end, it is unclear that there is a U.S. person who is offering or selling the futures contract. What then is the Commission's statutory basis for regulating access to foreign boards of trade?

The Commission's suggestion that "trading volume attributable to direct access from the U.S. may trigger a unique regulatory interest" is not a basis to expand its power under the Act. First, we believe that the Commission's mandate to protect markets and customers is circumscribed by the statutory language of Sections 4(a) and (b), which is the product of a considered legislative decision that may not be disregarded. Until this language is revised by Congress to better align with current market conditions, the Commission is obligated to focus on matters that pertain to location, not to the quality of regulation, if any, in the market's home jurisdiction, the nature of the contract, its impact on the U.S. economy, etc. Second, we do not believe this test can be meaningfully applied. For example, no one would rationally suggest that Eurodollar futures and options contracts should be redundantly regulated by various foreign regulators simply because substantial volume flows from outside the U.S. or because the contract itself serves as a benchmark for interest rates on U.S. Dollar deposits in foreign banks. Nor would anyone rationally suggest that CME should be directly requlated as an exchange in Germany simply because it offers CME European Heating Degree Day futures contracts based on temperatures in Berlin and Essen.

In our view, indicia of "location" should take into consideration factors related to where an exchange's infrastructure, management, headquarters or operational situs is predominantly located. . The mere suggestion that a terminal in the U.S. may mean that an exchange is not "located outside the U.S." is incredibly dangerous to the efforts of U.S. exchanges to establish a global business base. The U.S. cannot expect to regulate the operations of foreign exchanges without a reactive regulatory response against U.S. exchanges doing business in foreign jurisdictions.

PUBLIC POLICY

U.S. futures exchanges have demonstrated an ability to successfully respond to competition when operating on the relatively level playing field created by CFMA. We encourage the Commission to continue its efforts to eliminate protectionist measures and establish a rational policy for cross-border trading access. CME is deeply concerned that an effort to extend the Commission's jurisdictional reach over foreign boards of trade based on the normal structural incidents associated with cross border trading is in conflict with the Act and sound public policy.

For example, a U.S. exchange serving EU customers is likely to maintain an EU sales office and sales representatives, an EU technical office or outsourced technical services to install and service networks, routers and terminals, banking connections, delivery facilities and data centers and/or communication hubs. In the near future, if distributed computing makes trade matching more effective, some part of the matching operations may occur in the EU. It is not difficult to imagine the adverse consequences if each of the jurisdictions in which these operations take place were to assert its right to regulate. CME opposes any action by the CFTC that might encourage foreign regulators to adopt a reactive regulatory stance toward foreign exchanges.

The current no-action strategy has been effective, but it has involved a range of inquiries that are irrelevant and do not appear to be a legitimate exercise of the Commission's statutory authority. We are concerned that the no-action process, as currently conducted, may not be consistent with the needs of the international marketplace. CME suggests a more limited inquiry. We propose that the Commission limit its inquiry to questions regarding the comparability of the regulatory regime in the foreign board of trade's home jurisdiction. Three of the factors currently considered in connection with no-action requests should be the focus of the inquiry: "(iv) the regulatory regime governing the FBOT in its home jurisdiction; (v) the FBOT's status in its home jurisdiction and its rules and enforcement thereof (including market surveillance and trade practice surveillance); and (vi) extant information-sharing agreements among the Commission, the FBOT, and the FBOT's regulatory authority." CME favors a regime that permits foreign exchanges that are subject to a responsible local regulatory regime in their home jurisdiction to make their products available for trading in the U.S. by permitting direct or indirect access to their electronic matching system. This policy should be adopted in conjunction with responsible foreign regulators adopting a corresponding policy permitting access on similar terms to CFTC regulated exchanges.

This approach focuses the Commission's attention on the legitimacy of the home regulator rather than on the broader inquiries that have informed the no-action process to date. Commissioner Lukken has clearly explained how regulatory cooperation can work to insure fulfillment of the Commission's statutory responsibilities without stifling advances in cross-border business.[2]

> "Foreign regulatory coordination is vital. Agencies like ours do not have the resources to sufficiently monitor the breadth of the global marketplace and its participants. We must rely on the expertise of other regulators, both domestic and foreign, in fulfilling our public mission. This does not mean that the CFTC should subrogate its interests—quite the opposite—the CFTC must continue to vigorously monitor that its core principles are

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[2] CFTC Commissioner Walt Lukken, *The Derivatives World is Flat*, delivered at the ISDA Energy, Commodities and Developing Products Conference, Houston, Texas (June 14, 2006).

being met. However, the means for accomplishing this mission may involve coordination among those regulators abiding by the highest global standards."

This approach is also consistent with Congress' mandate. In 1982, Congress stated that the Commission, in regulating intermediaries located in the U.S. "may adopt different rules for different foreign boards of trade and markets," acknowledging that the FBOT's home regulatory environment should be taken into account in connection with the regulation of U.S. vendors of its contracts.. H.R. Rep. No. 97-565, Part I, at 53 (1982), *reprinted in* 1982 U.S.C.C.A.N. at 3871, 3902. Congress stated that it "expect[ed] that the Commission will, if necessary, draw distinctions under its regulations between [foreign] exchanges that pose no significant dangers to customers in the United States and others that do." *Id.* at 85, 1982 U.S.C.C.A.N. at 3934.

We also believe it is appropriate to formalize the process: this suggests that there should be a standard application form and that the foreign exchanges be granted a status in the U.S. comparable to the Recognized Overseas Investment Exchange status in the U.K. CME will support amendment of the Act to eliminate any question respecting the Commission's power.

CONCLUSION

We appreciate the opportunity to comment on the appropriate treatment of foreign boards of trade. If you have any questions or comments, please do not hesitate to contact me or Richard H. Lamm, Managing Director, Regulatory Counsel at 312/930-2041.

Respectfully submitted,

Craig S. Donohue

Craig S. Donohue