UNITED STATES OF AMERICA

BEFORE THE

COMMODITY FUTURE TRADING COMMISSION

In the Matter of the Application of the U.S. Futures Exchange, L.L.C. for Designation as a Contract Market

Wednesday, February 4, 2004

1155 21st Street, N.W.
Washington, D.C. 20581

The hearing in the above-entitled matter convened, pursuant to notice, at 10:00 a.m.

BEFORE:

JAMES E. NEWSOME, Chairman

WALTER L. LUKKEN, Commissioner

SHARON BROWN-HRUSKA, Commissioner

STAFF PRESENT:

JAMES CARLEY

PATRICK McCARTY

MICHAEL GORHAM

GREGORY MOCEK

P R O C E E D I N G S

CHAIRMAN NEWSOME: The meeting will come to order. This is a public meeting of the Commodity Futures Trading Commission to discuss the application of the U.S. Futures Exchange, Limited Liability Company, for contract market designation.

I'll entertain a motion that the Commission business requires that this meeting be held on less than seven days' notice.

COMMISSIONER LUKKEN: So moved.

COMMISSIONER BROWN-HRUSKA: Second.

CHAIRMAN NEWSOME: All those in favor, say aye?

[A chorus of ayes.]

CHAIRMAN NEWSOME: Any opposed?

[No response.]

CHAIRMAN NEWSOME: The vote is unanimous, and I'll take this opportunity to welcome members of the public, industry, and media to this open meeting of the CFTC to listen to a staff briefing and recommendation of U.S. Futures Exchange application for designation as a designated contract market.

In addition to those of you who are in attendance this morning, we have on the phone listening to the Commission's proceedings many others. I hope everyone present picked up the materials outside the room. I would point out that this

document was prepared by our staff so that the Commission could use it for this briefing today.

For those of you on the phone, certainly I'd like to welcome you to this meeting as well. And while you obviously were not able to pick up the hard copy of this document today, if you don't already have it, you can immediately access it on our website, www.cftc.gov, on the front page under the CFTC Spotlight.

As for the format of today's meeting, the Commission will first hear a staff presentation on the application of U.S. Futures Exchange for contract market designation, which is the Commission's highest level of regulation for a marketplace. At the conclusion of this presentation, the Commissioners will have the opportunity to ask questions of the staff. After questions, Commissioners will have their closing comments, a vote can be taken, and the meeting will be adjourned.

For those members of the media on the phone who have follow-up questions, please direct them to the Office of External Affairs. We will do our best to answer those questions in a timely fashion.

Before we get started, I'd like to thank all of our staff members who worked so hard on this application. And while I can't publicly list everyone who contributed to the final product, I want each of you to know that the Commission deeply

appreciates the efforts you have made to prepare us for today's meeting.

I will take this opportunity to thank the interdivisional team that worked diligently on this application for the past several months. That team was led by Duane Andresen from the Division of Market Oversight. Also from that division he was assisted by Don Heitman, Martin Murray, Kevin Pepple from the Chicago office; from the Division of Clearing and Intermediary Oversight, Andy Chapin; from the General Counsel's Office, Julian Hammar; from the Enforcement Division, Bill Hoar; and Harvey Theberg representing the Office of Information Resources Management.

Additionally, I would also like to thank David Van Wagner, Nancy Yanofsky, and Rick Shilts of the leadership team of the Division of Market Oversight for the many late nights they've devoted to this project, especially in the midst of many other competing Commission projects.

And, last, I would like to give special thanks to the Commission's division directors that led the staff in this effort: Mike Gorham, Pat McCarty, Jim Carley, Jim Overdahl, and Greg Mocek. I admire your dedication and work ethic, and I appreciate your professionalism.

With that, I'll ask my colleagues if they would like to say anything before we get into the staff presentation. Commissioner Brown-Hruska?

COMMISSIONER BROWN-HRUSKA: Well, thank you, Mr. Chairman. It is a pleasure to finally gather here today for what may be someday seen as a historic moment in the history of futures trading, both in this country and globally.

I would also like to recognize the efforts of the staff. In the Commodity Exchange Act, Congress instructs the Commission to promote responsible innovation and fair competition among boards of trade, other markets, and market participants. This morning, we are gathered here to consider an application consistent with this instruction of the Act.

As we all are aware, the application of the U.S. Futures Exchange to become a designated contract market raised a number of unique and challenging issues. The staff has not only had to endeavor to be inquisitive and thorough in their task, but they also needed to be open-minded and fair. And I just really would commend the staff, the Division of Market Oversight, Clearing and Intermediary Oversight, the interdivisional team.

I would also like to commend you, Chairman Newsome, for your astute management of the challenges posed by this market designation and your leadership on this issue. I look forward

to our deliberation today, and I just want to thank you for the opportunity to consider the matter.

CHAIRMAN NEWSOME: Thank you, Commissioner.

Commissioner Lukken?

COMMISSIONER LUKKEN: Thank you, Mr. Chairman. I think I'll reserve my comments until after the deliberations here this morning. But I would like to echo the thoughts of my colleagues here today. There was lots of work that went into this project, more work than probably ever devoted to any project at the Commission. So I appreciate the long hours, the tireless efforts of all of our staff. It's very much appreciated, and it's not lost on us as Commissioners. So thank you very much.

I would note that I've never seen so many ties on our staff as this morning.

[Laughter.]

COMMISSIONER LUKKEN: So that's also good. You guys are looking great this morning.

So, with that, I'll turn it over to you and let the presentation begin.

CHAIRMAN NEWSOME: Thank you, Commissioner.

The staff presentation will be presented by Dr. Mike Gorham, head of the Division of Market Oversight, and by

Patrick McCarty, the General Counsel. So at this time, Dr. Gorham, we'll turn it over to you to start.

DR. GORHAM: Thank you. Good morning.

Mr. Chairman, Commissioners, you have before you the staff analysis of the application of the U.S. Futures Exchange, L.L.C. which we will refer to as USFE in this conversation, and which is also known by its marketing name, Eurex U.S., to become a designated contract market.

I'd like to note that there were at least 30 different Commission attorneys, economists, IT specialists, futures trading specialists, and others from every office and division in the Commission that were involved in this project in one way or the other. The core team, as the Chairman mentioned, was involved every step of the way, and it's been a great pleasure for me personally to have worked with such a bright, talented, and really dedicated group of people in this project.

What I would like to do is give a quick overview of the applicant, USFE, and then explain the process by which staff has reached the recommendation that it is making to the Commission.

USFE is a Delaware corporation. It is owned by two other Delaware entities, all of these subject to the laws of the United States. One of these is a Delaware limited partnership made up largely of former shareholders of the now inactive

BrokerTec Exchange. They own 20 percent of USFE. The entity holding the other 80 percent of USFE is a Delaware corporation that is a separately capitalized and wholly owned subsidiary of Eurex Frankfurt, AG. I should note two things at this point.

First, the applicant is largely foreign owned. Second, there is nothing in the Act or in the regulations that causes us, or even allows us, to discriminate between applicants that are foreign owned and those that are domestically owned.

The applicant's contracts would trade on an enhanced version of the a/c/e trading system, a fully automatic electronic trading system that has been used by the Chicago Board of Trade for just over three years ending this past December. One of the enhancements that has been made, in fact, is that the number of options strategies recognized by the centralized trading system has been increased from seven to 45. This is particularly important because options traders, both in Europe and in the U.S., typically have avoided electronic trading of options. And one of the reasons is because of the small number of strategies that are recognized. So this significantly increases the attractiveness of this platform for options traders.

Like many other U.S. DCMs, USFE's rules also provide for certain types of trading away from the centralized

market. Thus, they allow trading of EFPs, EFSs, and block trading.

As with several recently designated contract markets post-CFMA, USFE has outsourced clearing services and regulatory services. The USFE has entered into an agreement with the Clearing Corp, a registered derivatives clearing organization. The C Corp under a different name has provided clearing services to the Chicago Board of Trade since 1925. We thus have a reasonable degree of familiarity with this organization.

The exchange has also contracted with the National Futures Association to assist it in carrying out its various self-regulatory responsibilities such as market surveillance, trade practice surveillance, and financial surveillance.

The NFA, which will also provide the exchange with investigative, disciplinary, and arbitration services, has been reviewed by Commission staff in conjunction with four prior contract market designations. We thus also have a reasonable degree of familiarity with this organization.

Let me turn to the review process. When Commission staff conducts a review of an application to become a designated contract market, what it is doing is reviewing the applicant's rules, bylaws, agreements, and other

materials to ensure that the applicant will be operating in compliance with the eight designation criteria and the 18 core principles established by Congress.

Typically, the applicant comes to us first with a draft application, which we review and then offer advice in order to ensure that the application, when it comes in as a formal submission, is as complete as possible. USFE, in fact, did come in to us with such a draft a full six weeks before its formal September 16th filing.

Much of the DCM review involves a review of many pages of documents. The applicant has submitted, and we have reviewed, rules and bylaws, agreements with C Corp and the NFA, revenue Commission agreements with several former equity holders of BrokerTec, which have now become equity holders of USFE, membership applications and agreements, the operations manual, the user's guide, and the disaster recovery plan, among other things.

In addition to receiving written submissions, the Commission team pays an on-site visit to view and discuss the exchange's operations, including the fairness of trade matching systems, the effectiveness of systems for monitoring for trading abuses and manipulation, and the readiness of the linkages between the exchange and its clearing and regulatory services providers.

As staff review these documents and systems, there are always additional questions that arise. During the review of USFE, staff sent four sets of written questions to the applicant. As part of the Commission's move towards greater transparency that took place last fall, any portion of the application and the applicant's responses to staff questions that were not considered confidential were posted on the Commission's website for the public to view and comment on.

The USFE's application has attracted, as you know, substantial public interest. The Commission received positive comments from three government agencies: the Treasury, the Federal Reserve Board, and the Federal Trade Commission. We also received positive comments from seven associations representing market participants.

We received, on the other hand, negative comments from the Chicago Board of Trade, the Chicago Mercantile Exchange, various current and former members of those exchanges, and several other individuals.

The Commission afforded interested parties two separate opportunities to comment on the application, and, in addition, the House Agriculture Committee convened a hearing to consider the merits of the application on November 6th.

In total, the Commission received 44 comment letters, four of which were received in the past few days, one of which was received only about an hour ago. We have reviewed every single one of those negative comment letters, including the ones that just came in today, to see if any of them pointed out any instances where the applicant did not, or was not likely to, comply with the eight designation criteria and the 18 core principles.

While a number of these comment letters raised interesting issues that were debated and discussed, we found nothing in these comments that made us feel the applicant had not or would not be in compliance with these criteria and core principles.

Mr. Chairman, Commissioners, the bottom line to our review is that USFE does meet all statutory and regulatory requirements for designation and does indeed comply with all eight designation criteria and all 18 core principles laid out in the Act.

Thank you.

CHAIRMAN NEWSOME: Thank you, Dr. Gorham.

Mr. McCarty?

MR. McCARTY: Thank you, Mr. Chairman and Commissioners. I have been asked to make a presentation on two issues: antitrust analysis and the undertakings.

First, with respect to antitrust, there are two provisions in the CEA which must be considered in relation to the USFE application: Section 15(b) of the Act and Section 5(d)(18) of the Act, Core Principle 18. You will find the staff's review and analysis related to antitrust on pages 37 through 43 of the memorandum which has been distributed. I'd like to summarize what's there.

Antitrust analysis starts with two critical issues: defining the particular good or service and then defining the relevant geographic market. We have determined that the relevant good or service to be exchange-listed and traded are U.S. Treasury futures and options. We've also determined that the relevant geographic market is the United States.

Our analysis of the current market for exchange-listed and traded U.S. treasury futures and options found the following: The Chicago Board of Trade is the dominant U.S. exchange for U.S. Treasury futures and options. They had over 99 percent of the market for such products in the last 12 months in the relevant geographic market, the United States.

On the other hand, USFE is a new entrant into this product market and geographic market. As a new exchange, USFE has no market power at present. On January 15th, Eurex

issued a press release announcing that they were acquiring BrokerTec. Eurex was acquiring BrokerTec and then merging it into a subsidiary of USFE. BrokerTec has been a U.S. DCM since June of 2001. It listed and traded U.S. Treasury futures and options, the relevant good or service. It also was located in the relevant geographic market, the U.S. BrokerTec, however, stopped trading operations on November 26, 2003. It is our understanding that BrokerTec only had 0.6 percent of the trading volume in the U.S. Treasury futures and options market. It is our conclusion that BrokerTec also did not have market power.

While neither USFE nor BrokerTec had sufficient market power to present significant antitrust concerns, the staff believed that it would be appropriate to engage in further antitrust analysis with respect to the terms of the Eurex BrokerTec acquisition as it related to the RCA agreements.

As noted above, seven firms entered into RCA agreements with USFE. These large FCMs and investment banking concerns are significant participants in the U.S. Treasury futures and options markets. The RCA agreements, which run for 36 months, are non-renewable, and are creditable against commission fees, obligate the seven firms to make $18 million in payments to USFE. It appears that the RCA agreements constitute the primary consideration for

the 20-percent equity stake which Exhange Place Holdings will receive.

After analyzing the RCAs, we believe that these agreements do not raise material antitrust concerns. We have reached this conclusion based on several factors.

First, the RCA agreements are very similar in structure to the RCA agreements which the Department of Justice did not object to in April 2003 in connection with the BrokerTec/ICAP transaction, where the cash treasury platform of BrokerTec was sold.

Second, the RCAs are of limited duration, only three years.

Third, these RCA agreements are not renewable.

Fourth, they only provide for an insignificant volume of transactions, significantly less than 10 percent of the total market of U.S. Treasury futures and options.

We also note the fact that the seven RCA participants have a greater economic stake in the Board of Trade than the USFE when one takes into account the value of the seats which those participants own at the Board of Trade. That would be a difference of $7 million, $25 million to $18 million.

Staff, in fact, believes that the RCAs will promote competition between USFE and the Chicago Board of Trade to

the benefit of consumers. In this regard, we note that CBOT execution and clearing fees have been lowered in the last year, based in part on the expected competition from USFE. We would also note that the FTC comment letter was very supportive of the USFE application as a new entrant to promote competition.

Based on the foregoing, and when reviewed against the standards in Section 15(b) and Core Principle 18, staff believes that the RCAs are acceptable.

I've also been asked to briefly describe the undertakings which USFE and the Clearing Corporation submitted to the Commission. You will find the staff's review of the undertakings on pages 136 through 139 of the memorandum.

My letter dated January 26, 2004, USFE submitted four voluntary undertakings to the Commission. The four undertakings were:

One, not to file with the Commission prior to the third quarter a request to implement a cross-border clearing link;

Two, USFE would not establish a cross-border clearing link without prior Commission approval or permission;

Three, USFE would provide the Commission with a copy of any non-traditional incentive plan it intends to implement at least 30 days prior to implementation;

And, four, USFE agreed not to operate BrokerTec without prior Commission approval or permission.

By letter dated January 23, 2004, the Clearing Corporation submitted three voluntary undertakings to the Commission. The first of the three undertakings from the Clearing Corporation was similar to the USFE undertaking relating to the cross-border clearing link. The second and third undertakings related to netting, offsetting, cross-margining, and portfolio margining agreements.

The Commission has the clear legal authority to impose conditions in the order approving USFE's application to become a DCM. The Commission may accept the voluntary undertakings proffered by USFE and the Clearing Corporation. I would note that the Commission does not have to accept all the terms of the undertakings if it does not choose to do so. If the Commission wants any of the undertakings to be legally enforceable, they must be included in the Commission's order.

The proposed order includes six of the seven undertakings which were offered by USFE and the Clearing Corporation. In particular, we note that the restriction on

USFE and the Clearing Corporation not being able to file proposals prior to the third quarter with the Commission related to the global clearing link is not included.

Based on the fact that USFE and the Clearing Corporation are specifically required in the undertakings to submit to the Commission for prior review and approval or permission any plans related to clearing USFE-listed and traded contracts through a clearinghouse which is not a CFTC- or SEC-registered entity, the third quarter restriction was viewed as being unduly restrictive and being unnecessary. For that reason, it is not included in the proposed order.

Thank you very much. That is the end of my presentation.

CHAIRMAN NEWSOME: Thank you, Mr. McCarty.

Dr. Gorham, based upon these presentations, do you have a recommendation to the Commission from the staff?

DR. GORHAM: Mr. Chairman, I do.

CHAIRMAN NEWSOME: If you can find it?

DR. GORHAM: If I can find it.

[Laughter.]

DR. GORHAM: Mr. Chairman, Commissioners, the Division of Market Oversight, with the concurrence of the Division of Clearing and Intermediary Oversight and the Office of the

General Counsel and the consultation of the Division of Enforcement, recommends that the Commission designate the U.S. Futures Exchange, L.L.C., as a contract market by issuing the attached order, which includes six undertakings by U.S. Futures Exchange and the Clearing Corporation, and simultaneously approve USFE's proposed bylaws and rules as set out in the designation memorandum and supporting documents before you.

CHAIRMAN NEWSOME: Okay. Thank you for that recommendation, Dr. Gorham.

Before we get into the question and answer period, I would invite Enforcement Director Gregory Mocek and the Director of DCIO, Jim Carley, to join the table and participate in any questions asked by the Commission. Thank you.

What I intend to do this morning is to rotate questions around with the Commissioners until such time that all questions from my colleagues are answered. And, Mr. McCarty, I would start with you.

In an issue that was raised by the Congress and in a number of comment letters, and as I testified before the congressional hearing to this extent as well, is the staff confident that USFE and the Clearing Corp cannot initiate a clearing link without prior Commission approval?

MR. McCARTY: Yes, based on the explicit undertaking that is in the proposed order.

CHAIRMAN NEWSOME: Okay. As a follow-up to that, Mr. Carley, and I guess more specifically, a primary concern was that U.S. contracts could be cleared in a foreign jurisdiction without any kind of U.S. oversight. Would you describe the process that needs to take place before contracts traded on USFE could be cleared, say, by Eurex Clearing in Frankfurt?

MR. CARLEY: Certainly, Mr. Chairman. Good morning, Commissioners.

As you correctly point out, an often expressed concern with the clearing of U.S.-designated contract market transactions by an overseas clearinghouse which is not a designated clearing organization under the CFTC's jurisdiction raises several key issues. It raises a lot of administrative issues, but policy issues, some of the big ones that have been pointed to, are that this would involve holding the funds or the other assets of U.S. customers in an overseas location. That gives rise to two concerns: one, that those assets would be in a place where they may be beyond the jurisdiction of the CFTC or other federal financial regulators; and they may be subject to bankruptcy law or other insolvency law regimes that are different than

the expectations that were held by the parties to the transaction when it was entered into on a U.S. contract market.

Some of the other policy issues that this raises is it would involve the commingling of funds meant to margin contract market positions with other assets. That is prohibited by Section 4(d) of the Commodity Exchange Act unless the Commission takes affirmative action to permit such commingling, which it has in certain locations, so it's certainly not impossible, but it is prohibited without prior approval.

The bottom line is that if contract market positions are going to be cleared by any clearinghouse, that clearinghouse under the Commodity Exchange Act must be a DCO. And that would mean that a foreign clearinghouse that wanted to clear USFE transactions overseas would have to go through the application process. Much like the application process for a DCM that Mike described, our division has a process. It involves careful consideration of all the information provided by the applicant. Almost every one of these applications does involve some novel issue. The division certainly would endeavor to handle this application like any other very expeditiously, but there are novel issues to consider.

And when you get into a foreign clearinghouse, as Mike pointed out, there is nothing that requires or even permits the Commission to treat such an application any differently, but there are certain aspects of an application in that category that are complicated. And foreign insolvency law is just one example.

CHAIRMAN NEWSOME: Okay. Thank you, Mr. Carley.

In that same vein, I know that the questions raised by members in the congressional hearing and in some of the public comment letters that we got was with regard to U.S. contracts going to foreign jurisdictions. Would it be the same process for another portion of a proposed clearing link, like plans to clear Eurex contracts at the Clearing Corp? Would that be the same process that you just described?

MR. CARLEY: Not necessarily, and here's why: The full clearing link arrangement that has been described, to some extent publicly and in some conversations with CFTC staff, is a, if you will, bilateral situation in which at some future point a customer could elect to have his or her transactions cleared either in Germany or in Chicago by the Clearing Corp, respectively, or the Eurex AG Clearinghouse. That is the full long-term strategy as we understand it at this point.

There are different parts of that strategy that raise different regulatory issues. As I mentioned, the clearing of U.S. transactions overseas raises one set of issues. The clearing of German transactions in the U.S., while providing a number of benefits, also raises some regulatory issues. For example, you could have the commingling of funds used to margin a position on a foreign non-contract market with funds used to margin positions on a U.S. DCM. And, again, that kind of commingling, absent prior Commission approval, is not permitted under the statute.

It would not require a new DCO application, however, because the Clearing Corp is, in fact, a DCO in good standing, subject to periodic risk-based and risk-focused reviews by this Commission. But, nonetheless, there would be certain regulatory actions that would have to be taken in the area of customer funds and perhaps other areas to permit it. It is not something that could be done automatically. Could it be done--could that take place more expeditiously than a full DCO application as we discussed a few minutes ago? More than likely yes. But we can't offer an unconditional guarantee of speedy, immediate processing.

CHAIRMAN NEWSOME: Okay. Thank you, Mr. Carley.

Commissioner Brown-Hruska, any questions?

COMMISSIONER BROWN-HRUSKA: Thank you, Chairman. I think that was one of my questions as well in regard to the clearing linkage.

Just basically, you know, if you look at other clearing relationships that we've seen in the past, for example, the SIMEX CME arrangement, does that--did that require a designation, to your knowledge, in terms of, as I understand it, if you execute a euro-dollar contract on the CME, you could choose to clear it on SIMEX. And if you do that on SIMEX, you could choose to clear it on the CME. What type of approval process did that necessitate? And I would assume this is a similar process here.

MR. CARLEY: That's an excellent question, Commissioner, and it's not only a complicated issue, it's actually a very intellectually interesting issue. Several points right at the outset.

First, the arrangement you describe has generally been characterized by the Commission and by the participants to it as a mutual offset system, CME SIMEX. Another point to keep in mind is that it predates the CFMA, and prior to the CFMA there was not a separate category of designation for clearing organizations. Prior to the CFMA, of course, there was sort of a reliance on the traditional view that a clearinghouse and an

exchange are integrated, although even prior to the CFMA we saw business models that didn't exactly match that.

The Commodity Exchange Act does have a definition of "clearing." It is embedded in the definition of a designated clearing organization--or derivatives clearing organization, rather. And it's a rather broad definition. It has three prongs, and if an entity--if a clearing organization touches on any one of these three prongs, it is deemed to be clearing. And those three prongs are: Does it settle or net out obligations among participants on the contract market? Or does it involve some substitution of the credit risk of the house for the credit risk of any participant? Or does it involve any sort of mutualization of risk among the participants? And if the activities of a clearing organization touch on any one of those with respect to a particular contract market, then it is clearing.

Now, that means that activities which fall well short of what we're used to seeing take place at a traditional full-scale clearing organization are clearing, nonetheless defined as clearing under the Act, and, therefore, anyone performing those activities must be a DCO.

Getting to your particular example, as I say, that predated the CFMA, so there was certainly no--and the provision that I describe was added to the Commodity Exchange Act. That

definition was added by the CFMA. There was certainly no consideration at the time whether CME SIMEX needed to come in as a DCO because there was no such thing at the time.

I haven't spent a lot of time going back and thinking about if that were presented to us today whether or not that would require a DCO application. Conceivably it could if it were to be examined in the light of the statute today. But that's purely a speculative conjecture on my part. I don't know that.

So it seems clear to the Division of Clearing and Intermediary Oversight that the activity described here, which would be the clearing of DCM contracts from Chicago in Frankfurt, would require a DCO application.

Now, I guess--does that fully answer your question?

COMMISSIONER BROWN-HRUSKA: Yes, I think so. I was just sort of looking for some context in terms of a level playing field and how we deal with--how we've dealt in the past with other types of arrangements that are being--that may be proposed to us in the future in terms of the plans that they have. So thank you very much.

MR. CARLEY: You're welcome.

COMMISSIONER BROWN-HRUSKA: I will just start out kind of--I wanted to ask a more specific question to the application that we are considering today. I understand that in the

process of considering the USFE application there was a concern that future plans should be included in order that we have a complete application to consider. And I believe, however, that the entities such as the USFE, the Chicago Mercantile Exchange, the Chicago Board of Trade, in fact, all of these markets are evolving, just trying to continually change, come up with new products and innovate in order to stay ahead of the competition.

That said, I understand and accept the fact that the USFE, the Clearing Corporation, and the Commission really wanted to establish certainty with respect to the substance of the USFE's application.

The undertakings made by USFE and the Clearing Corporation are an effort to sort of establish comfort in this regard. However, the recommended order doesn't contain any sunset provisions or otherwise provide for the eventual lifting of the undertakings agreed to by USFE and the Clearing Corporation.

In essence, they seem to apply a level of regulation or at least restriction, to some extent, on these entities that was not contemplated by the CFMA.

And so, in other words, the USFE and the Clearing Corporation will, for the foreseeable future, be subject to these restrictions that aren't really those that are on other

exchanges or clearinghouses. So, to me, this seems to set a precedent of establishing sort of extra-regulatory requirements on similarly situated competitors when circumstances allow. So what I want to ask is, you know, whether the staff has considered the anti-competitive effects of imposing these restrictions on the USFE and the Clearing Corporation, particularly in light of Section 15(b) of the Act, which instructs the Commission to endeavor to take the least anti-competitive means of achieving the objective of the Act? And, also, did the staff consider placing some sort of sunset provision into the order or consider what circumstances these undertakings--under which circumstances these undertakings would be lifted? Does the USFE have to formally petition, or the Clearing Corporation, do they have to formally petition the Commission to lift these restrictions or undertakings?

MR. McCARTY: I'll jump in on that. I think the first point I would make is that the Commission and, I guess, the staff are both very mindful of competitive forces and interested in making sure that there's a level playing field with respect to the futures industry. So I think that the thing is that your point is to whether, in fact, this is a materially different level of regulation. I think we've thought about that. So there was some consideration about that, and I don't think that we believe that there actually is

a material imposition being put upon the applicants. And I would also note that the applicants actually made these voluntary proffers to us to get the Commission more comfortable with what's in their application.

I think the thing is that it's important to remember is why these undertakings here. The fact is that the Chairman testified before Congress in November with respect to the clearing link. He indicated at that time that it was his view and the Commission's view--and I think it's the same position that Mr. Carley has just articulated--that to implement a clearing link, there would have to be some form of affirmative Commission action to permit that to be put in place. We were a bit unsure and I think we're still somewhat unsure as to exactly what the terms of the proposed clearing link will be. But I think that there was no confusion, that there would have to be some type of affirmative Commission action to permit the clearing link to be put in place.

That as a background, on December 16th, USFE, Eurex, and the Clearing Corporation issued a press release which indicated that they were going to start business on February 1st and that the global clearing link would be implemented on March 28th. There was no qualification as to receiving regulatory approvals to start business or implement the clearing link. We were mostly concerned about the clearing link part of that because

there were further press reports indicating that both Eurex and the Clearing Corporation were of the opinion that they did not need any advanced approval or affirmative action from the Commission to implement the clearing link.

The staff held a meeting with representatives of USFE, Eurex and the Clearing Corporation on January 7th to determine what their view of their authority versus the Commission's authority related to implementing the clearing link that they had identified in their March--excuse me--in their December 16th press release.

In that context, in that meeting, they indicated to us that they had misspoke or had been misquoted and that, in fact, they agreed that to implement the clearing link that there would need to be some affirmative Commission action.

The undertakings that you find today actually merely clarify what had been the Commission's position that there would have to be some type of prior Commission review, approval or permission granted to permit implementation of the clearing link.

So I think that, as a background, that is why there are some undertakings in the order today. These clarify that, in fact, representations of what we believe our authority is. These undertakings indicate that, in fact, the applicants agree what they would have to do.

I think that your second point is whether there are any sunset provisions in the order. No, there are not. There was some discussion about that, but the fact is, is that, as you can see from the undertakings, as well as what the applicants have indicated, they will be back in front of the Commission fairly soon to talk about their further business plans that may occur at some point out in the future later this year or next year.

From that point of view, I guess they can request modification or the Commission, on its own, could go ahead and either relax or waive any of the conditions, undertakings that are in the order.

COMMISSIONER BROWN-HRUSKA: Thank you.

CHAIRMAN NEWSOME: Thank you, Commissioner.

Commissioner Lukken, any questions?

COMMISSIONER LUKKEN: Thank you, Mr. Chairman.

This is for Mr. McCarty. I hate to keep firing at you, but I think it's important, from the outset, to understand the legal requirements that are required for becoming a designated contract market, not only for designation, but also for maintenance of being a designated contract market. If you could just briefly go through, and I know Dr. Gorham touched on this in his presentation, what the burdens of proof are in becoming a designated contract market, what is required, maybe

touch on some of the core principles and what sort of discretion the Commission has in approving or not approving the designated contract market application.

MR. McCARTY: I'm going to actually rely on Director Gorham for some discussion about the specific core principles, but I'll give you a bit of an overview and actually hand it off to Mike.

Under 6(a) of the Act, persons desiring to be a designated contract market shall make application to the Commission. The application has to include a showing that they comply with the conditions set forth in the Act, and that would generally be the 8 designation criteria in Section 5(d), as well as the accompanying 18 core principles.

I would note that Section 6(a) also requires that there has to be a sufficient assurance that the contract market will continue to comply with the requirements of the Act, and this requires continued compliance with core principles.

I would note that 5(d)(1) is actually clear on this continued compliance issue. It states that "to maintain the designation, the Board of Trade shall comply with the core principles specified in this subsection." So maintenance of your designation means that you have to continue to comply with the core principles that are in 5(d).

I'd also note that, in fact, if there is some question related to whether in fact a designated contract market continues to comply with the core principles, our Commission rules specifically address this. Part 38.5 of our rules which is entitled, "Information Related to Contract Market Compliance." Under subsections (a) and (b), we have the ability to ask or request that a designated contract market provide the Commission information related to their compliance--continued compliance with the core principles.

So, to that extent, the 18 core principles, it's not just a showing initially that the contract market complies with them, it must show continued compliance. With that, I'll hand it off to Dr. Gorham.

DR. GORHAM: I don't want to go through, and obviously you don't want me to go through, all of the 18 core principles, but some of these are really easy to comply with. They're almost somewhat trivial and done automatically by exchanges--things like making sure that the marketplace knows what prices are being discovered on the market, end-of-day-summary-type things, high, low, close, volume, open interest, these kinds of things, record-keeping requirements, even governance. We go into governance and suitability on boards and disciplinary committees, this sort of thing.

One of the most important core principles has to do with preventing manipulation. That's one of the most important things the Commission does, and this applies not only to making sure that the exchange has in place means by which they will receive and process large trader information, so that they know every single day who all of the large traders are in each market, but that, when we get to the next stage, and they actually submit contracts to us--and I think it's clear to everyone that, under the CFMA, contracts can simply be certified after a designation--the contracts have to be designed in such a fashion that they are not subject to manipulation.

So when you look at the designation criteria and the core principles, they essentially give us markets that are well-designed and protect the public interest.

Finally, I should say that with respect to our own ongoing review of these markets, we do rule enforcement reviews of every single exchange. We do these roughly once every two years. We go in, and we make sure that they are enforcing their rules. We make sure that they're doing what they should be doing with respect to market surveillance, market compliance, et cetera. And, finally, we also have an electronic system by which we sort of look over the shoulders to the exchanges, to some extent, and we watch how trades are

being conducted to ensure that there are no trading abuses. We make sure that the exchanges are doing that, but we also do our own analysis of things like the possibility of trading ahead, trading against and things like that.

So that's a quick summary of where we are with respect to core principles.

COMMISSIONER LUKKEN: I also understand we do SRO audits as well. So NFA, I guess in this instance, would be the entity that is constantly overlooking to make sure that there is compliance with the core principles as well?

DR. GORHAM: Yes.

MR. CARLEY: That's correct, Commissioner. DCIO does also have a role in ensuring the ongoing compliance of a designated contract market with its core principles. A big part of our effort and focus in DCIO is on the clearinghouses, who themselves have a set of criteria and core principles with which they must comply, and we do intensive reviews, on a periodic basis, of those clearinghouses. But when we go to look at a clearinghouse, if it's an integrated clearinghouse and exchange, we'll look at the exchange and some aspects of its SRO responsibilities at the same time.

For example, Core Principle 11, on the DCM side, requires that the contract market do two things. First, if its transactions are cleared, they've got to be cleared through a

DCO. So we have to confirm that that's taking place and, second, the contract market has to have in place rules, and systems for enforcing those rules, that ensure the financial integrity of the firms that are clearing members and trading members of that exchange and for the protection of customer assets.

So, yes, we look, we also look at exchanges, as they perform that self-regulatory function. And as you know, exchanges do not perform financial surveillance of a comprehensive nature over each of their members, but, rather, they perform one level of financial surveillance over their clearing members, and a different level of their nonclearing members.

The National Futures Association serves as the DSRO or primary auditor, if you will, of non-member firms. And so just as we look at exchanges to make sure they're properly performing SRO responsibilities, we look at the NFA in the same capacity on a periodic basis.

COMMISSIONER LUKKEN: Thank you.

CHAIRMAN NEWSOME: Thank you, Commissioner Lukken.

The CFTC has been a leader in recognizing global marketplaces, and certainly through our cooperation with international groups such as IOSCO, through numerous

Memorandums of Understanding with foreign jurisdictions, I think the CFTC has been quite active in this area.

Mr. Mocek, this question is for you, and I guess, more specifically, what has been the CFTC's enforcement relationship with the German regulator BaFin, and are you confident about the Commission's ability to go after wrongdoers who may be located in Germany?

MR. MOCEK: Good morning, Mr. Chairman, Commissioner Lukken, Commissioner Brown-Hruska.

Last year, we worked on dozens of international enforcement matters. What is important to us in white-collar crime prosecution and investigations is boiled down to a number of things: One, tracing money, getting bank records; two, reconstructing trading; and, three, interviewing witnesses.

Over the last 15 years, we have had an excellent relationship with BaFin in that they promptly assisted us in doing all of those things. We share information with BaFin on a routine basis. A lot of that is not in the public domain since our investigations are confidential. We regularly receive referrals from BaFin and follow up on those referrals with investigations, and as a result, we are prosecuting people within our marketplace. They have helped us investigate and prosecute a number of cases.

In DOE's opinion, when it comes to enforcement matters, BaFin is one of the toughest international regulators in the international derivatives markets. They are extremely aggressive, and the Germans are not hesitant to use their criminal powers to put people behind bars. On the formal procedures that you mentioned earlier that we have in place, there are a number of them. We have 21 formal bilateral MOUs with international regulators; those assist us in helping our investigators gather information abroad every day. We have people designated in the Division of Enforcement who, on a daily basis, work with international regulators and prosecutors, such as BaFin.

Back to BaFin. BaFin signed an MOU, a bilateral MOU, with us in October of 1997, and that Memorandum of Understanding deals with a number of things: it deals with the exchange of information; taking statements is dealt with in that MOU; obtaining documents from witnesses is dealt with, as well as inspecting futures contracts and respective businesses on either side of the ocean.

So we have the bilateral MOU, which was signed--and very effective, I might add--in '97; but also there is the IOSCO MOU that BaFin signed, along with 22 other countries, and that was signed in October 2003. The IOSCO MOU basically covers the same territory as the bilateral MOU, but it has a couple of

added protections. One of the added protections is that it provides for rigorous screening of all of those participants; i.e., countries, that sign the MOU; and monitoring of compliance with the information that's within the context of the MOU.

And then, finally, there are a couple more agreements that we have in place with BaFin. The Boca Declaration and the exchange MOU are two that deal with addressing exposures. As people trade on multiple exchanges, there are certain triggering points; and at those triggering points, we start sharing information to make sure that there is not a manipulation occurring in various markets at one time.

So, with regard to the formal agreements in place, we feel like we have every tool imaginable right now internationally.

From the legal perspective, the same is true. 6(c) is quite broad. We have the ability to take testimony of witnesses and gather information not only throughout the United States, but also of foreign individuals; and that authority is subject to the Federal Rules of Civil Procedure.

We can prosecute administratively or injunctively those violative activities that occur on Eurex. And as you know, the big hammer that we have is under Section 8. Should we suspect

a manipulation is occurring in the marketplace, we can shut the exchange down.

So, in the opinion of the Division of Enforcement, after reviewing this information quite extensively, and all of the relevant law and related factual scenarios, there is nothing unique about this situation to us. We have the proper relationships, the proper agreements, and the proper statute to pursue illegal conduct.

CHAIRMAN NEWSOME: Thank you, Mr. Mocek. That's certainly comforting to me, but I think it's comforting to Commissioner Lukken as he heads to Madrid to represent the Commission at the Technical Committee of IOSCO later today.

Commissioner Brown-Hruska, questions?

COMMISSIONER BROWN-HRUSKA: Thank you.

In fact, I was just going to ask a few questions, a couple of questions that are kind of related to sort of going forward and just my understanding of our process in dealing with these sort of special issues that have been raised.

One of them that I would like to know more about is, when the USFE, in fact, reached this agreement with BrokerTec, and they indicated in their undertaking that they will not operate the BrokerTec Futures Exchange as a contract market in reliance on the designation previously granted by the Commission to BrokerTec without Commission approval or permission, and so I

kind of have a general inquiry, which is, is it the opinion of the staff that a designation license is not generally transferrable? In other words, under what circumstances could an entity, whether an already-designated exchange or some other business, buy out an exchange and continue to operate it as a designated contract market?

MR. McCARTY: I'll jump in on this one again.

Commission regulations specifically address the change in ownership of a designated contract market under Part 38.5(c). The new owner shall file with the secretary of the Commission a certification regarding the change in ownership.

And just last year we actually had a filing made in connection with NQLX. That was the joint venture between Nasdaq and Liffe, which is a futures exchange, but it's focusing on security futures products. As you may remember, Nasdaq sold their 50-percent interest to Liffe. Liffe provided us with a notification that they were assuming full ownership of the exchange. They continued to operate that exchange in the way that it actually had been approved by the Commission.

Your question about are they transferrable, I think the answer is that clearly the Commission has to receive notice that there has been a change in ownership. I guess the thing is, is that there is a question as to whether, in fact, the change in ownership is really circumventing the designation

process or not. I think the issue came down to, in the Nasdaq-Liffe situation, where Liffe provided us a notice that they were assuming full ownership of the contract market. They were going to continue to operate NQLX exactly how it had been operated when the Commission had designated it to start with.

There was some question with respect to the BrokerTec transaction as to whether in fact Eurex was going to abandon its USFE application and utilize the BrokerTec license to implement what it had applied to us for. Our view was that, to the extent that they acquired the license, but then replace the clearing arrangement, and the regulatory services agreement and all of the other rules and bylaws that apply to the operation of the exchange, that that would be outside of the intention of 38.5(c), which contemplates just a change in ownership.

Actually, what it would be, if that was done, would be a wholesale change in the actual contract market. From the perspective of the Commission reviewing for completeness and passing upon the adequacy of compliance with the core principles, it was thought that if USFE were going to be attempting to do that, that we ought to have some understanding with them.

As it came up, and as you note from the undertaking, it was represented to us by Eurex, USFE and the Clearing Corporation that there was no intention of abandoning the USFE

application. They merely were going to hold the BrokerTec license in a subsidiary of USFE, and they were not interested in operating BrokerTec as an exchange. Based on this they said, to make the Commission feel comfortable about that, we will provide this undertaking voluntarily.

COMMISSIONER BROWN-HRUSKA: Sort of relatedly, with regard to self-certification, has the staff given, to some extent, and, again, this is just for informational purposes going forward, what types, in the undertaking we were asking that they actually come to us prior to self-certifying, have we given much thought to what types of things are appropriate for self-certification?

I know there's some guidance in the Act. What kind of guidance can we also give to those who may come to us in the future in terms of what types of things are appropriate for self-certification and what things do they need to come to us for approval for?

MR. McCARTY: I don't want to hog the mike, but I will answer that question, also. I think you're pointing out one of the undertakings that the C Corp provided, which is in the draft order. The fact is the self-certification requirements or at least what they have offered to us and what is in the order, is that The Clearing Corporation would provide the Commission with an ability to review, prior to self-

certification, any proposals or arrangements which are, with respect to clearing, netting, off-setting and other arrangements in a very limited arena. I think that one could say that those are primarily associated with the idea of the global clearing link that has been discussed.

To the extent that self-certification is restricted in some way, shape or form, it's just an analogue to the other undertaking that both USFE and C Corp agree that they will bring any type of clearing link to the Commission for prior review or approval and permission. The self-certification undertaking that they offered is actually very narrow. It would not apply to the contracts that they would be offering and other rule changes. The self-certification undertaking that they've put forth permitting us to review something before it's self-certified only relates to the clearing link side of the equation.

COMMISSIONER BROWN-HRUSKA: So, just broadly, the clearing link, anything with regards to a clearing link is what we would expect them to come to us or, of course, not--with regard to other matters. I'm sorry. I have a learning curve--

MR. McCARTY: Let me just answer that by referring you or letting Mr. Carley articulate a little more clearly on that point. "Clearing link" is not a defined term. Clearing, settling, off-setting, mutual off-sets, things like that are

technically probably not considered to be clearing, but they are part of what we would consider to be a clearing link, but I'll let Mr. Carley provide you with more information related to that.

CHAIRMAN NEWSOME: Before you do so, Jim, just in addition to Commissioner Brown-Hruska's question, it would be helpful, at least to me, as part of that, if you would clarify it. It is my understanding that this wouldn't prohibit them from self-certifying. It would simply ask them to come in and make sure that we're in agreement with what they wished to self-certify and that if, in fact, they haven't heard from us in 10 days, that they could go forward; is that part of this same question and answer?

MR. CARLEY: That's correct, and let me--that's a helpful clarification. That undertaking goes to our having the opportunity to clarify that a particular matter is not one which is appropriate for self-certification to begin with. And I think that's where the distinction lies. That's why I think perhaps language indicating anything connected with clearing linkage is perhaps unintentionally a little more broad than is appropriate.

Self-certification, the example that jumps to mind when you use that term is contract changes or rule changes, with regard to the contract market itself.

Clearinghouse operations, there are, in fact, clearinghouse rules, and those rules are changed and amended from time to time. New rules are added. And in that context, it's often a very appropriate mechanism for an exchange to, a clearinghouse to say, look, we're changing our rules with regards to the Guarantee Fund and the calculation of contributions thereto by clearing members. We'll certify to the Commission that this rule amendment that we want to undertake at the clearinghouse here continues to uphold the appropriate core principles for clearinghouses, and those things go to protection of customer funds, the adequacy of risk management performed by the clearinghouse, things of that sort.

A clearing link, it's almost, to say that a clearing link could be self-certified is almost to say that a contract market could be born into existence by self-certification. It's more than just amending the rules of a clearinghouse. It's actually instituting an entire new de facto clearing institution. So it's not like changing the terms and conditions of a particular corn contract or changing a rule amendment or amending a rule about voting within the board or things like that.

So that is I think what's contemplated here is, if an entirely new clearing institution, an entirely new clearing framework is going to be implemented, then the Commission

should have the opportunity to say, wait a minute, that's an order of magnitude many times beyond what is appropriate for self-certification. That is something that requires designation or an application process, and a lot of this comes back to the definition of "clearing" under the Act. It's a broad definition and the Commission has been granted the authority to interpret the Commodity Exchange Act. So, for someone to self-certify an interpretation of the definition of clearing under the Act, really would grossly supersede the Commission's authority to interpret the Act.

Maybe that's helpful. I'm not sure. I'm happy to expand on that.

COMMISSIONER BROWN-HRUSKA: I think that helps, and this has come up before when we get these certifi--rules, whether they're submitted for approval or whether they're self-certified. So I'm just wanting to get a sense of, you know, where the line is drawn, but I think that provides some guidance.

CHAIRMAN NEWSOME: Thank you, Commissioner.

Commissioner Lukken, any further questions?

COMMISSIONER LUKKEN: For Dr. Gorham. This is in regard to the Revenue Commission Agreement that former BrokerTec owners have agreed to.

When I first read this, obviously, this was an incentive to get seed volume going at the new USFE exchange, but I also saw that, and critics could point out that there was a potential for breaches of fiduciary duties and potential wash trade problems as a result of this.

I noted in the memorandum that you have addressed some of these points, but I thought, for the public record, it might be helpful to go through those checks that are in place to prevent breaches of fiduciary duty and also any sort of wash trading potentials.

DR. GORHAM: I'd be happy to. I should first point out that, while there has been a lot of focus on these Revenue Commission Agreements and the incentives that they may create, it's important to step back and think about the incentives that exist on the part of any FCM in a potential competition between the two exchanges.

For example, right now, as the general counsel pointed out, any member of the Chicago Board of Trade would have an incentive, because of the value of the seats that they own, to the extent they could, to direct order flow to the Chicago Board of Trade, as opposed to USFE. The same thing holds here.

Now, we do have the concerns that you expressed. Any time there is any incentive agreement before us, the two things that we are concerned about are. First, will there be any sort

of wash trading or other inappropriate fictitious trading for the sake of just pumping up volume and, secondly, will customers be abused in any way? Will the fiduciary responsibility that FCMs have towards their customers be abused?

With respect to this particular agreement, on the fiduciary side, first of all, the USFE has indicated that--well, it hasn't just indicated--it's clear in the agreements, that the only trades that can be used towards the credits, the prepaid credits, are proprietary trades from the firm. There's obviously no abuse of customers there because there are only nondiscretionary customer orders.

Our concern, of course, is whether there would be any case or would there be an incentive to take discretionary orders and somehow mask them as nondiscretionary orders. So there are several things that USFE has come forward and said that they will do in order to minimize the risk of any of these things happening.

The first is that they have said that the seven firms involved will issue disclaimers to their customers indicating the equity interest that they have in USFE.

Secondly, they will retain records of all of the decisions that are made regarding directing customer orders to particular exchanges. This will allow both the NFA and us,

when necessary, to go in and look for possible misclassification of these orders from discretionary to nondiscretionary.

And, thirdly, USFE has agreed to make known and clear to the NFA, their regulatory services provider, the participants involved and the specific dates and terms of the agreements so that NFA can conduct proper oversight. NFA is responsible for looking out for wash trading all of the time by all firms, but if there are particular concerns with particular firms at particular critical times, when there's a high incentive for them to meet a particular quota, they will be able to look out for those firms at those times.

So all of those things together make us very comfortable that the USFE's incentive plan is one that would meet our core principles and would not result in either an abuse of customers or in wash trading.

COMMISSIONER LUKKEN: And just to make clear, a nondiscretionary customer is somebody who requests--these are normally, I understand, institutional customers. They request that they want their trades to be transacted at a certain exchange. These are people making decisions on their own, not at the discretion of the broker they're going through.

DR. GORHAM: And there are two ways that this could happen, Commissioner. Either at the time that the order is put

in, the customer says, "I want this to go to the Chicago Board of Trade" or "I want this to go to USFE" or there could be instructions given up front that any orders I give you on treasuries, they go to the Board of Trade or they go to USFE.

In both of those cases, the broker has no discretion as to where to direct the order because the customer has already made that decision.

COMMISSIONER LUKKEN: So we know the time period this will be occurring, so NFA is going to be watching during this time period.

DR. GORHAM: Correct.

COMMISSIONER LUKKEN: The transaction is identified that will be credited towards the RCA agreements.

DR. GORHAM: Correct.

COMMISSIONER LUKKEN: So I think, aptly, our general counsel has called this "shooting fish in a barrel." If any sort of activity might happen, any sort of wash trade activity, we have a pretty good comfort level that we're going to have a good handle over this.

DR. GORHAM: I wouldn't use exactly that same marine metaphor, but, yes.

COMMISSIONER LUKKEN: Well, he's our general counsel.

[Laughter.]

COMMISSIONER LUKKEN: Thank you very much.

CHAIRMAN NEWSOME: Thank you.

I don't have any further questions at this time, so Commissioner Brown-Hruska?

COMMISSIONER BROWN-HRUSKA: I don't have any either.

CHAIRMAN NEWSOME: Mr. Lukken?

COMMISSIONER LUKKEN: I think I'm fine, too. Thank you.

CHAIRMAN NEWSOME: Good. If there are no further questions, I would like to invite my colleagues to provide any closing remarks that they might like to add. And Commissioner Brown-Hruska, we'll ask you to go first.

COMMISSIONER BROWN-HRUSKA: Thank you so much, Mr. Chairman.

As a student of markets for many years, the significance of the U.S. Futures Exchange's application for designation as a designated contract market is not lost on me. The rise of Eurex, the parent of U.S. Futures Exchange, and its successful endeavor to establish an electronic marketplace in Europe for futures trading was probably the most significant innovation in the futures industry since the Chicago Board of Trade invented the first financial futures contract on Ginnie Mae mortgage-backed certificates in 1975.

Ironically, these two great exchanges, which have recently worked as partners to establish electronic trading in the United States, are now poised, along with another great

exchange, the Chicago Mercantile Exchange, to vie as competitors in the markets. Certainly, this has raised consternation with some with the thought of a foreign entity attempting to move in on what has been, for more than a century, an American institution.

But as with other sectors of the economy, and perhaps most notably, say, the financial sector, the futures markets are increasingly a global industry. I would note, however, that without the Chicago Board of Trade and the Chicago Mercantile Exchange, and the innovations that they have brought to the futures industry, we would not sit here today discussing Eurex or its start-up exchange, the U.S. Futures Exchange.

Moreover, without the assistance of these two American exchanges, it's unlikely that we would have seen the establishment and growth of futures markets across Europe and Asia to the extent we have. I do not expect for one second that these exchanges will rest on their laurels. I expect them to build on their substantial competitive advantages and to take their innovative spirit to an even higher level in products, markets and services here and abroad.

As an advocate of global markets and the economic potential that such markets create, I look forward to the innovations and progress that will come from the competition between the exchanges. In fact, before the U.S. Futures

Exchange even traded one contract, we have seen the benefits of competition in the form of lower exchange trading fees for customers.

As I have mentioned in the past to many of you here, I am a strong proponent of the development of global clearing links that offer the promise of greater capital efficiency and potential savings for customers in the hundreds of millions of dollars. I look forward to learning the details of these developments in the coming months.

And for the City of Chicago, there's a prospect of another gem to be added to their crown of futures markets. Contrary to the parochial concerns and dire predictions that have surfaced throughout the extended comment period, I believe that the entry of the U.S. Futures Exchange into the U.S. futures industry will usher in a new era of futures trading in the United States and globally.

As we have seen in other markets--for example, the U.S. options market--I don't believe that this will be a "winner take all" proposition. I believe that all will be winners, that volumes will continue to expand as more users are attracted to the options and futures markets, and our markets will evolve to offer more useful risk management products to consumers and investors both here and abroad.

It is, thus, my pleasure to cast a vote today in the application of the U.S. Futures Exchange as a designated contract market.

I'd also like to take this opportunity to wish all of the exchanges a success in their future endeavors and again thank them for their comments, advice and even their criticism.

I noticed in the clips, just a couple days ago, where it said, "U.S. Groups Nag the Futures Regulator as Eurex Approval Drags On." I just wanted to, I look around the room, and I see a lot of "naggers," and I just wanted to actually thank everyone for all of their great comments, and their criticism, and their concerns. I think your input has really made us, made our staff, made us think, made us do a better job, and I, for one, appreciate the opportunity to fully consider this matter and render my decision.

Thank you, Chairman.

CHAIRMAN NEWSOME: Thank you, Commissioner.

Nagging was a pretty soft way to put it.

[Laughter.]

CHAIRMAN NEWSOME: Thank you.

Commissioner Lukken, any closing comments?

COMMISSIONER LUKKEN: Thank you, Mr. Chairman.

I know this has been touched on before, but I'd like to again thank the staff of the Commission for a thorough

presentation this morning and the diligent work they have put in over the past few months on this process. This has been a truly massive effort, involving all divisions of this agency, and I wanted to thank everyone involved at the Commission for their hard work.

I would also be remiss if I did not recognize my own staff's work in this process. I very much appreciate their efforts as well.

As you know, Mr. Chairman, I came to the Commission a year-and-a-half ago after serving on the staff of the Senate Agriculture Committee, one of our agency's authorizing bodies. I was privileged to participate in the development and writing of the Commodity Futures Modernization Act of 2000. I was present when legislators agreed to its passage, and when the CFMA was ultimately signed into law by President Clinton. As a result, I have strong views about this law and its public objectives.

One of the enumerated objectives of the law is to foster fair competition among exchanges, and that is why we are here today. Congress understood that competition is the very essence of our free-market system. It is the force that sparks the inventive spirit, lowers the costs of goods and services for consumers, and raises standards of living for our society.

Since Congress tasked our agency in statute to promote fair competition, I take this responsibility seriously. But the existing exchanges are not unarmed in this battle. Much of this CFMA was devoted to untying the hands of the exchanges by providing them with the necessary tools and products to succeed on a global scale. The CFMA transitioned the regulatory structure of the CFTC from prescriptive rules and regulations to a principles-based approach.

Unlike rigid regulations, core principles allow exchanges the flexibility to use best practices in achieving statutory requirements.

Furthermore, the CFMA provided exchanges with the authority to implement new products and rules without prior CFTC approval, through a self-certification process. Before the CFMA, approval time for new futures products was, on average, 90 days. Today, the process of listing a new futures contract is almost instantaneous. Exchanges have taken advantage of this new authority by certifying 438 new products since the CFMA's enactment, a sizable jump from the 175 new products approved during the three years preceding the CFMA. These tools, and others, afforded by the CFMA have allowed existing exchanges to respond rapidly to the evolving and expanding marketplace.

I expect this innovative resilience of the current markets, already displayed in anticipation of USFE's arrival, will continue long into the future. But to meet our public mandate, Congress did not task this agency with promoting unbridled competition. They specified fair competition as our goal, and as regulators, it is our job to ensure fairness of process.

In regard to the USFE application, certainly there has been ample opportunity for public discussion and comment. For the first time, the Commission posted the nonconfidential documents of a designated contract market application on our website for public viewing. In addition, our agency held two comment periods to solicit public input.

One of our oversight bodies, the House Agriculture Committee, held a hearing on the USFE proposal--the first time, to my knowledge, that one of our oversight committees has ever conducted such a public meeting. And several members of Congress have written us to ensure this agency is properly fulfilling its statutory mandate.

Today's public meeting of the Commission--the first since I've joined as Commissioner, and one that I strongly supported--is further testament to the transparency of this process. Such openness bestows fairness and legitimacy on important policy decisions. I have read the designation

memorandum before us, all 142 pages of it, and believe that this public document, along with the answers to our questions here this morning, indicate that the staff has carefully and prudently evaluated the issues raised by the USFE application. Staff has considered all of the comments seriously, and that analysis is reflected in its memorandum.

In addition, I place great weight on the comments of the Federal Reserve Board of Governors and the Department of Treasury, as well as the analysis submitted by the Federal Trade Commission. All of these agencies point out the potential economic benefits that will ensue from the designation of another U.S. futures exchange.

The bottom line is that after all of this is taken into account, the Commission has appropriately carried out its responsibilities to protect the public interest in the matter of the USFE application. I do want to credit staff for completing this application in a timely manner, despite the magnitude of the application and the several unique issues presented within.

The USFE application is before us today well in advance of the March 16th completion date required by statute. I have been disappointed to read stories in the media that implied that the Commission has somehow been dragging its feet on the application. I take strong exception to these assertions. Any

slowing of the process has been caused solely by the novel issues raised with the Commission during the latter stages of the submission period. Given the complexity of the concerns, staff should instead be commended for completing the analysis in time to allow a Commission vote within three days of USFE's target start-up date.

It is also important to address the concerns of some critics that if USFE's application is approved today, the exchange will be able to restructure itself free from regulatory scrutiny, a so-called regulatory bait-and-switch. These individuals misunderstand the oversight role provided by the Commission--by statute, as was explained by our staff today. Section 5(d) of our Act states that to maintain the designation of a board of trade as a contract market, the board of trade shall comply with the core principles specified.

This recognizes that compliance is not measured by a snapshot in time, but rather is an ongoing duty of exchanges. Our staff is in constant daily contact with the markets we oversee to protect against violations of our statute. Our agency also conducts periodic rule enforcement reviews and self-regulatory organization audits as a means of monitoring these markets.

The fact is that the Commission's oversight of USFE would not end with an affirmative vote today. In a very real sense, it only would begin.

We are, as Commissioners, public stewards of the futures marketplace, with the substantial responsibility today of acting on an application for a new exchange. The documentation and the analysis has been presented to us and the recommendation has been made. All that remains is the vote. But before we do, I want to reiterate my confidence that should our vote be affirmative, the competitive forces unleashed by that decision will provide significant benefits to market users and the public in general. This is what Congress envisioned with the enactment of the CFMA and is what guides my vote today.

Mr. Chairman, I look forward to our consideration.

CHAIRMAN NEWSOME: Thank you, Commissioner.

I would like to thank both of my colleagues for those comments and point out that since the retirement of Commissioner Holum at the end of last year, I've become the old dog at the Commission. I came to the Commission in 1998 and brought to the job certain principles that I believe were important to doing the job well.

I believe that you must go out and get an understanding of business issues from the people who are actually involved in

the business. I believed that the hiring of quality professional staff at the Commission was vital. I believe that it was important to develop relationships with the market participants and customers in the industry that you can trust and then listen to them if you want to develop sound regulatory policy.

I also believe that you should never think that you are more knowledgeable than those people, although it is okay to challenge them from time to time. I believe that in tough situations you must be willing to listen to all sides, consider all arguments, but in the end, we must make decisions and stand behind them. But most importantly, I believe that you must always keep your word.

These principles have guided me in my decisionmaking over the five-and-a-half years of service both as a Commissioner and more recently as Chairman of this Commission.

Since the passage of the CFMA in December 2000 that Commissioner Lukken so ably spoke about, I have been focused on the Commission's implementation of that farsighted legislation and the way that it was intended by the Congress. In an oversight hearing last year, our authorizing committee in the House gave the Commission what I believe to be a positive grade for our implementation of the Act.

Implementation was challenging in some respects because the new Act required the Commission to retire most of its rigid prescriptive rules and adopt more flexible approaches to compliance with the Act. Flexibility is always more challenging than prescriptive rules, since the former requires one to think more creatively and make decisions accordingly. Of course, the decisions that come out of this structure are also more open to criticism, since they are based on interpretations, which can differ from commenter to commenter.

While it has been challenging, I remain a solid supporter of this more flexible approach because it has resulted in fewer regulatory restrictions on innovation, technological progress and competition in the futures industry. I firmly believe all of these things are good for the U.S. position in and the general operation of the marketplace.

Given the inherent subjectivity that goes along with flexibility, we have been careful not to disadvantage one group over another in our review of new rules and applications and have worked hard to develop regulatory policy that yields a level playing field. This has become especially important as new players enter the field. USFE is certainly a good example since it is a new, formidable player.

It was important to me that we accomplish several goals in our review of this application:

One, that we ensured that the application demonstrated, to our satisfaction, that the core principles for contract market designation were successfully met;

Two, that the public was able to comment on all parts of the application that were not commercially sensitive or legitimately protected;

Third, that the Commission consider all comments, respond to each of them and then be able to defend our decisions;

Four, that we felt comfortable going forward with the designation, and by this I mean primarily that the applicant had a clear understanding of what was expected from a regulatory standpoint. I, personally, needed to have comfort that the applicant was willing to cooperate with the Commission in establishing a positive working relationship as it begins operations in the U.S. market under our regulatory oversight. The new, flexible structure inspired by the CFMA depends on solid working relationships between the Commission and those that we oversee.

And, finally, I believe that once all legitimate issues were appropriately addressed, the Commission should act quickly on this application.

Now, it's no secret to probably anyone in this room that there were bumps in the road during the consideration of this application and that those public disagreements both lengthened

and expanded the Commission's review of this application. This was the first time the Commission reviewed an application under such detailed scrutiny by the public and the Congress. There were several industry participants who, at times, even became emotionally charged, and from both sides of the aisle, I might say, and in constant contact with the Commission, either orally or through multiple comment letters expressing many legitimate issues that were raised and certainly their views.

Because of the unprecedented high level of interest, this may be the most thorough review ever undertaken by the Commission. Additionally, the Commission and the applicant had limited experience in dealing with each other, which at times led to differences of opinion, most notably over the Commission's regulatory authority. These public disagreements led to, among other things, questions from Capitol Hill asking if I had reversed my opinion since testifying before the House Agricultural Committee earlier, where I was asked to outline the Commission's authority related to consideration of the USFE application. Obviously, I have not.

These issues are behind us now. I believe that we have achieved a level regulatory playing field through our analysis of this application, meaning that there will be no regulatory advantages nor disadvantages when USFE enters the United States markets.

As for whether or not USFE will be successful in this marketplace, only market users will have an opportunity to decide, not the regulator. I have stated many times that this is the way that it should be.

Given today's staff presentation and multiple other briefings conducted during the last several weeks leading up to this meeting, I believe the core principles for contract market designation are indeed satisfied.

I am pleased how the Commission's process of considering this application has been transparent from the beginning. Our decision to hold two public comment periods and this public meeting to formally consider the application also signify that.

I am satisfied that we have fairly considered and adequately addressed all questions raised throughout the process, including those received during the comment period from our congressional hearings and through follow-up letters from interested members of Congress.

I am also confident that our decisions are both defensible and consistent with the framework of the CFMA.

Most importantly, I am comfortable that USFE now understands our regulatory expectations, and I look forward to continuing the development of this relationship. I believe that it is now certainly headed in an appropriate direction.

Finally, I believe it is important to point out that the Commission is acting upon this application as expeditiously as we possibly could have. This has been very important to me, as I do not believe the government should determine winners and losers through artificial barriers or regulatory delays.

I, as Commissioner Lukken pointed out a moment ago, have been disturbed by recent reports suggesting that we were stalling the approval process. I can assure the public that this is far from the truth. Our staff has worked tirelessly, late at night, and on weekends, and even through recent inclement weather.

I, again, think it's worth mentioning that even with all of the interest in this particular application, we are considering approval roughly six weeks prior to the end of the 180-day statutory time frame.

If there is nothing further in terms of questions or comments from my colleagues, I will entertain a motion that the Commission issue an order designating U.S. Futures Exchange, Limited Liability Company, as a contract market and simultaneously approve the amended and restated bylaws, sections and rules, as recommended in the memorandum from the Division of Market Oversight, dated February 2nd, 2004.

COMMISSIONER LUKKEN: So moved.

COMMISSIONER BROWN-HRUSKA: Second.

CHAIRMAN NEWSOME: Thank you.

All in favor, say aye.

[Chorus of ayes.]

CHAIRMAN NEWSOME: Any opposed?

[No response.]

CHAIRMAN NEWSOME: The vote is unanimous.

If there is nothing further, then, I will entertain a motion to adjourn the meeting.

COMMISSIONER LUKKEN: So moved.

COMMISSIONER BROWN-HRUSKA: Second.

CHAIRMAN NEWSOME: All in favor, say aye.

[Chorus of ayes.]

CHAIRMAN NEWSOME: Any opposed?

[No response.]

CHAIRMAN NEWSOME: The vote is unanimous, and the meeting is adjourned.

Thank you.

[Whereupon, at 11:40 a.m., the proceedings were adjourned.]