

COMMENT

July 3, 2002

By Facsimile

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

Re: ECP/ECE Petitions

Dear Ms. Webb:

This letter is written in response to the request for comments on the proposal by IntercontinentalExchange, Inc. (Intercontinental) to expand the category of eligible commercial entity (ECE) under the Commodity Exchange Act (CEA) to include floor brokers and floor traders registered in the United States or authorized by the U.K. Financial Services Authority (FSA) trading on an exempt commercial market (ECM). The comments set forth below are submitted on behalf of Intercontinental, a Delaware limited liability company that operates an electronic platform (the Platform) for the trading of physical commodities and derivative products on such commodities among ECEs. Intercontinental operates as an ECM, having submitted a notice of operation as an ECM to the Commission on December 27, 2001. As an ECM, it is exempted from most Commission regulation pursuant to section 2(h)(3) of the CEA. Intercontinental also owns the International Petroleum Exchange (IPE), a U.K. FSA regulated futures exchange for the trading of energy futures products. Intercontinental is pleased to submit its comments to the proposed ECE definition, and appreciates the opportunity to provide relevant suggestions for your consideration.

Under the CEA, eligible commercial entities include: certain types of eligible contract participants (ECPs) who in connection with their businesses, make or take delivery of the underlying commodity or provide hedging and risk management services in the commodity; ECPs other than natural persons or state or local governments that regularly enter into transactions in commodity derivatives; and certain types of

Ms. Jean Webb,

-2-

investment funds. The Commission has the authority to expand the ECE definition to include floor brokers and floor traders. Pursuant to Section 1a(11) – the term “eligible commercial entity” includes, with respect to an agreement, contract or transaction in a commodity –

- (C) such other person as the Commission shall determine is appropriate and shall designate by rule, regulation or order.

The Commission has already issued a rule pursuant to this authority with respect to Derivative Transaction Execution Facilities (DTEF). 17 C.F.R. Section 37.1 provides:

- (b) Definition. As used in this part, the term “eligible commercial entity” means, and shall include, in addition to a party or entity so defined in Section 1a(11) of the Act, a registered floor trader or floor broker trading for its own account, whose trading obligations are guaranteed by a registered futures commission merchant.

Intercontinental suggests the following criteria for eligible floor brokers and floor traders on an ECM:

- (i). U.S. registered floor brokers or floor traders or U.K. authorized floor traders;
- (ii). the floor broker or floor trader must be a member of a designated contract market (DCM) or a U.K. futures exchange or otherwise have trading privileges on a DCM or a U.K. futures exchange;
- (iii). the floor broker or floor trader must have as a part of its business the business of acting as a floor broker or floor trader but need not have any connection or experience in the underlying physical commodity; and
- (iv). the floor broker or floor trader is an eligible contract participant (ECP) or, if the floor broker or floor trader is not an ECP, its trades on the ECM are guaranteed by a clearing member of a U.S. or U.K. recognized clearing organization that is itself an ECP.

Intercontinental is pleased to offer responses to the Commission’s request for comment on specific aspects of the proposed ECE definition. In general, however, we suggest that the relief the Commission mandates be broadly based, applicable to any floor brokers or floor traders (U.S. or U.K.) that wish to be considered ECEs for purposes of trading on an ECM. For your convenience, we have included the Commission’s questions before our responses.

Ms. Jean Webb,

-3-

1. *As noted above, NYMEX's petition would limit OTC trading by floor brokers and floor traders acting as ECPs such that the counterparties to their trades must not be floor brokers or floor traders. NYMEX stated that it did not intend for this limitation to apply to floor brokers and floor traders acting as ECEs and trading on ECMs. In support of this determination, NYMEX stated that the Exchange could not ensure compliance with the counterparty restriction because ECMs may permit transactions to be conducted anonymously between counterparties. The Commission understands, however, that at some ECMs, traders have the capability of specifying the entities that are acceptable counterparties. In light of this capability, the Commission asks whether it would be reasonable and prudent to maintain a restriction on eligible counterparties, at least with respect to ECMs that provide for such a counterparty pre-approval mechanism.*

We do not believe that the Commission should impose restrictions on eligible counterparties trading on the Platform, other than requiring that they qualify as ECEs. As a service to its participants, Intercontinental provides credit and risk management support capabilities for no additional cost. The Platform allows ECEs to pre-approve trading counterparties and to establish credit limits for trading with each counterparty. Use of this credit management system is entirely voluntary, and it is designed to provide market participants with maximum flexibility and control over their trades. The credit management system is an additional feature to be used in connection with the Platform's trade execution facilities, but Intercontinental is not required, by contract or applicable law or regulation, to maintain these capabilities. Because participation on the Platform is limited to ECEs, all participants are sufficiently sophisticated to make their own credit determinations with respect to other participants, either by utilizing the Platform's credit risk management function, or by establishing separate credit arrangements with other participants. Moreover, one of the advantages of ECMs that makes them attractive to many market participants is their flexibility and requiring maintenance of a function that ECMs and markets participants might later decide is unnecessary will limit the flexibility of ECMs and is unwarranted.

For these reasons, we do not believe that it would be reasonable for the Commission to require Intercontinental's participants to use this credit management system or for Intercontinental to make this system available to its participants. We note that the Commission currently does not impose any counterparty restrictions on trades executed through the Platform. Intercontinental has proposed that floor brokers and floor traders must qualify as ECPs or that their trades be guaranteed by a clearing member of a recognized clearing organization. The satisfaction of these requirements reduces any concern by potential counterparties, including other floor brokers and floor traders,

Ms. Jean Webb,

-4-

regarding the credit or collection risk posed by the execution of trades with floor brokers and floor traders.

2. *The Commission notes that the NYMEX and Intercontinental petitions reflect different terms and conditions with respect to floor brokers and floor traders acting as ECEs. Based upon these distinctions, the Commission requests comments regarding whether the transactions that could be entered into by floor brokers and floor traders as ECEs on ECMs should be limited to any of the following: (a) specifically identified contracts; (b) transactions that would be cleared; (c) commodities in which the broker or floor trader had trading expertise; (d) transactions for which the floor broker or floor trader was guaranteed by an Exchange clearing member; or (e) in some other way.*

(a) *Specifically identified contracts.* We believe that floor brokers and floor traders should be permitted to execute transactions in all exempt commodities pursuant to Section 2(h)(3) of the CEA. The CEA, as amended by the CFMA, generally defines three categories of ECE:

- (i). Commercials who deal in the underlying physical commodity;
- (ii). Dealers and market makers; and
- (iii). Collective investment vehicles that generally are liquidity providers.

Categories (ii) and (iii) recognize that traders with no direct connection to the underlying physical market are eligible and valuable contributors to the efficiency of commercial markets. The CEA does not currently limit any category of ECEs by contract type. Including floor brokers and floor traders as ECEs is consistent with the CFMA and would recognize the value of floor brokers and floor traders as both liquidity providers and dealers and market makers. This approach also reflects the fact that floor brokers and floor traders understand trading markets and are sophisticated and capable as traders to the same extent as commercials. This sophistication is not limited to specific contract types, and floor brokers and floor traders would be valuable participants trading in all exempt commodities on the Platform.

(b) *Transactions that are cleared.* We believe that transactions should not need to be cleared in order for floor brokers and floor traders to be included in the ECE definition. Clearing reduces credit risk for counterparties to a trade by having a third-party guarantee the payment and delivery obligations of each principal to the trade, thereby reducing, for each of them, the credit risk posed by the other. Intercontinental proposes, however, that the floor broker or floor trader must be an ECP or that its trades

Ms. Jean Webb,

-5-

must be guaranteed by a clearing member of a recognized clearing organization that is itself an ECP. These requirements will provide sufficient financial backing, to the same extent available in the case of other categories of ECEs, without a requirement that the transactions be cleared through a central clearing facility.

(c) *Commodities in which the broker of floor trader has trading expertise.* As stated under (a) above, the categories of ECE defined under the CFMA recognize that traders with no direct connection to the underlying physical market are eligible and valuable contributors to the efficiency of commercial markets.

We therefore believe that floor brokers or floor traders should not be limited to trading in particular commodities in which they have trading expertise. One of the reasons that floor brokers and floor traders desire to trade on ECMs such as the Platform is to have access to a wider range of products and contract types. By creating a more flexible regulatory framework and legitimizing trading in particular derivative instruments, the CFMA fostered expansion in commodities and derivative financial instrument trading. Preventing floor brokers and floor traders from trading in new commodities would hinder the realization of this purpose of the CFMA. Intercontinental purposes to require floor brokers and floor traders to be registered and have as a part of their business the business of acting as a floor broker or floor trader. We believe that floor brokers and floor traders satisfying these requirements would have sufficient qualifications and experience to trade in any commodity product on the Platform.

The public policy supporting an expansion of the ECE category is not served by restricting the permissible commodities. As recognized in NYMEX's petition, allowing floor brokers and floor traders to participate expands the pool of potential counterparties for OTC market participants, increases competition and efficiency, enhances price discovery and reduces liquidity risk. Floor brokers and floor traders are desirable because of their expertise in trading, not their specific commodity expertise.

(d) *Transactions for which the floor broker or floor trader was guaranteed by an Exchange clearing member.* Intercontinental proposes that the floor broker or floor trader must be an ECP or that its trades must be guaranteed by a clearing member of a recognized clearing organization that is itself an ECP. When a floor trader or floor broker qualifies as an ECP, the floor trader or floor broker has been deemed to be sufficiently responsible to execute trades by the CEA, and there is no need to require further mitigation of credit risk by having a clearing member guarantee the floor broker's or floor trader's payment obligations. However, when a floor broker or floor trader does not satisfy the qualifications for an ECP, it is appropriate to require that a clearing member of a recognized clearing organization that is itself an ECP guarantee the trades in order to mitigate the credit and collection risk created by executing trades with a floor broker or floor trader.

Ms. Jean Webb,

-6-

3. *In its petition, Intercontinental states that there would be no meaningful distinction between allowing floor brokers and floor traders to trade as ECEs on a DTEF, as the Commission has already permitted, as compared to trading as ECEs on an ECM. The Commission requests comment on this assertion, and particularly on whether there should be any distinction in the treatment of floor brokers and floor traders as ECEs based upon the different regulatory regimes applicable to DTEFs and ECMs.*

The primary regulatory difference between ECMs and DTEFs is that DTEFs must comply with certain "core principles." These "core principles" include: monitoring trading and enforcing compliance with rules; making certain information regarding prices and price ranges, volume and open interest publicly available if the Commission determines that the contract performs a price discovery function in the cash market; recordkeeping; applying fitness requirements for board members, market participants and others; and addressing potential conflicts of interest. The regulatory concerns addressed by these "core principles" primarily relate to the protection of the integrity of DTEF markets rather than particular participants within those markets. For this reason, DTEFs do not provide floor brokers and floor traders with significantly more protection than would ECMs.

The current ECM regulatory framework similarly provides the Commission with sufficient authority to protect the integrity of the market. The Commission has real-time access to the Platform's trading screens and can observe and evaluate prices and trading activity on a real-time basis. In the event that the Commission detects possible problems in the market, such as manipulation or attempted manipulation, it has the authority to take action against the appropriate market participants. Discussions have already been held between the Commission and Intercontinental regarding the provision to the public of certain pricing information for these markets that may perform a price discovery function. Moreover, the Commission also retains antifraud authority, in addition to its antimanipulation authority, with respect to transactions on the Platform and can bring actions to protect market participants against fraud.

Since trading on the Platform is entirely electronic, there are no trading rules to be enforced because buy and sell orders are electronically matched by the Platform. Intercontinental applies rigorous standards to the selection of directors and all of its board members have significant experience in the commodity trading industry and many are executives of major corporations in the industry. The final "core principles," those relating to recordkeeping and potential conflicts of interest, do not affect floor brokers and floor traders or their counterparties to trades any more than they affect current ECEs.

Ms. Jean Webb,

-7-

For these reasons, we believe that the presence of floor brokers and floor traders on the Platform does not require any additional regulation beyond that which already exists under the ECM regulatory framework. Our position is consistent with the CFMA which was designed, in part, to provide a more flexible and less burdensome regulatory framework for futures and derivatives markets.

4. *In addition to U.S. registered floor brokers and floor traders, Intercontinental's petition requests ECE treatment for U.K. authorized local member floor traders. Intercontinental's petition also broadly describes the qualification requirements that such floor traders are subject to under the FSMA. The Commission seeks general comment on whether ECE treatment should be extended to any non-U.S. registrants and, if so, what standards the Commission should use to evaluate the qualifications of such persons.*

We believe that U.K. floor traders who are authorized persons under the FSMA should be included in the definition of ECE. U.K. floor traders, because they transact business as a principal on the floor of an exchange either on their own behalf or on behalf of other floor traders, carry on the regulated activity of dealing as principle (Article 14 of the FSMA (Regulated Activities) Order 2001 (RAO)) and must be an authorized person under the FSMA.*

To become authorized persons, floor traders must meet fitness and proper standards, put in place proper internal systems and controls, have competent and prudent management and conduct their affairs with due skill, care and diligence. An authorized person is subject to FSA rules including capital and conduct of business requirements. In addition, U.K. futures exchanges monitor the activities of floor traders and have the authority to sanction them in the event of their improper conduct.

We believe that because the FSMA provides such extensive authorization standards for floor traders, there should be little concern about permitting these parties to trade on the Platform. In particular, the FSA conduct of business requirements satisfy exactly the types of concerns that potential counterparties might have when trading with U.K. floor traders. These conduct of business requirements include the following obligations:

- A firm must conduct its business with integrity

* There are proposals pending to enable locals to trade on the IPE without having to become an authorized person under the FSMA. The relief requested by Intercontinental only applies to those floor traders that are authorized persons under the FSMA.

Ms. Jean Webb,

-8-

- A firm must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems
- A firm must maintain adequate financial resources
- A firm must observe proper standards of market conduct.

The FSMA and FSA standards ensure that like U.S. floor brokers and floor traders, U.K. floor traders understand trading markets and are sophisticated and capable counterparties to trades.

This approach is consistent with the action already taken by the Commission under Part 30 of its Rules, pursuant to which it has already recognized the comparability of the FSA as a regulatory authority. Under the exemption afforded by Part 30, FSA members are permitted to market foreign futures and option products to U.S. persons without being registered with the Commission, based on the comparability of the U.S. and U.K. regulatory schemes. Allowing U.K. floor traders who are authorized by the FSA to trade on the Platform as ECEs, therefore, would be consistent with the approach taken by the Commission in granting Part 30 relief to FSA members.

Including U.K. floor traders within the ECE definition recognizes that the commodity trading markets are now global in scope, encompassing corporations and individuals that operate within various states and regulatory systems. The global nature of the commodity trading markets is especially apparent on electronic, Internet-based exchanges such as the Platform. The FSA is a legitimate non-U.S. regulatory body whose extensive regulatory regime and controls should be recognized and taken advantage of by the Commission by allowing authorized U.K. floor traders to trade as ECEs.

Ms. Jean Webb,

-9-

We appreciate this opportunity to comment on the Proposal. Please feel free to contact the undersigned at any time if you wish to discuss this Proposal further.

Sincerely,



Kenneth M. Raisler

cc: David Goone
James Falvey
(IntercontinentalExchange)