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**Introduction**

At a time of rapid change in financial markets driven by technology, integration, and consolidation, we commend the Commission for holding this hearing to explore questions important to the ongoing development of open, efficient, and well-regulated trading. We appreciate the opportunity to appear before the Commission to express our views.

The primary question you pose is whether there is a point at which a foreign board of trade ("FBOT"), which allows direct access to its trading system from the U.S., has such substantial contacts with the U.S. that it should be required to register with the Commission as a designated contract market ("DCM"). The real focus of your inquiry, as we understand it, is to determine whether a specific, at least partially quantifiable test ought to be articulated to assist the Commission in defining that point, thereby providing greater regulatory clarity. For reasons that we will elaborate on, we think the qualitative and flexible approach embodied in the Commission's existing no-action regime makes more sense. That regime provides the Commission with the flexibility needed in a dynamic market to make sound decisions about whether FBOTs ought to be required to register in the U.S.

**The No-Action Regime is the Best Tool for Deciding Whether U.S. Registration Is Needed**

In our view, the foundation of the no-action process—deference to comparable home state regulation, consent to jurisdiction, and bilateral information sharing arrangements—is sound and should be retained. No-action relief is granted only after staff has conducted a thorough review—one that addresses many of the same issues that concern the Commission in considering an application for registration as a DCM under the core principles set forth in Section 5 of the Commodity Exchange Act—at the end of which the Commission is confident that the exchange is a *bona fide* FBOT subject to a comprehensive, and comparable, regulatory scheme in its home state.

As the Commission noted in the *Federal Register* release, the staff considers among other factors: (i) membership criteria (including financial requirements); (ii) various aspects of the automated trading system (including the order-matching system, the audit trail, response time, reliability, security, and, of particular importance, adherence to the IOSCO principles for screen-based trading); (iii) settlement and clearing (including financial requirements and default procedures); (iv) the regulatory regime governing the FBOT in its home jurisdiction; and (v) the FBOT's status in its home jurisdiction and its rules and enforcement thereof (including market surveillance and trade practice surveillance).

Let's pause for a moment and consider what it means to say that an FBOT is subject to a comprehensive, and comparable, regulatory scheme in its home state. In the case of the United Kingdom, the Commission has determined that the regulatory regime of the Financial Services Authority ("FSA") is comparable to the Commission's own regulatory program. Among other things, the FSA statutory and regulatory structure provides for: prohibitions on



fraud, abuse, and market manipulation; financial and other fitness criteria for industry participants; reporting and recordkeeping requirements; procedures governing the treatment of customer funds and property; sales practice and other conduct of business standards; and provisions designed to protect the integrity of the markets.

Since the FBOT must be properly licensed in its home state, its own regulator will have determined that the exchange is fit and proper and, to this end, will have considered, albeit in considerably more detail, many of the same factors that the Commission itself considers in granting no-action relief.

For example, to acquire and maintain its status as a Recognized Investment Exchange in the UK, LIFFE is required by the FSA, among other things, to: retain specified financial resources; operate its markets with appropriate concern to the protection of investors; maintain high standards of integrity and fair dealing; prevent abuse, including market manipulation; ensure that trading is conducted in an orderly and fair manner; maintain suitable arrangements for trade reporting and the clearing and settlement of contracts; monitor compliance with its rules; enforce its rules; investigate complaints with respect to its business; maintain rules to deal with the default of its members; and cooperate with other regulatory bodies through the sharing of information or otherwise.

Of course, implicit in the license granted by a home state regulator such as the FSA is a determination that the exchange has a sufficient nexus to the jurisdiction to make regulation appropriate. A license certifies to all that the home state regulator intends to fulfill its obligation to oversee the activities of that exchange (including through cooperation with all relevant regulators) in accordance with applicable laws and regulations, and is satisfied that it will, in fact, have the ability to adequately monitor and supervise that exchange.

The Commission's no-action relief, of course, is not based solely on a finding that the FBOT is subject to a comprehensive and comparable regulatory regime. It is also subject to extensive terms and conditions. In particular, (i) information-sharing agreements among the Commission, the FBOT, and the FBOT's regulatory authority must be in place; (ii) the FBOT and each member of the FBOT that conducts business under the no-action relief must consent to the Commission's jurisdiction with respect to those activities; and (iii) those members of the FBOT must agree to provide to the Commission, the Department of Justice and, if appropriate, the National Futures Association, prompt access to original books and records maintained at their U.S. offices.

In addition, the FBOT must provide the Commission, upon request, with information necessary to evaluate the continued eligibility of the FBOT or its members for no-action relief, to enforce compliance with the relief, or to enable the Commission to carry out its duties under the Commodity Exchange Act and Commission regulations. Among other things, upon request, the FBOT must provide information showing that it continues to satisfy the criteria for designation in its home country. The FBOT must also provide quarterly or, upon request, more frequent reports relating to trade volume emanating from U.S. terminals compared with total trade volume for each contract traded. Moreover, the FBOT must promptly provide the Commission with written notice of any material change in the information provided in its request for no-action relief and any material change in the FBOT's rules or the laws, rules, and regulations in the home jurisdiction relevant to futures

and options. Finally, as with any no-action relief, the Commission retains the authority to modify, suspend, terminate or otherwise restrict the terms of any no-action relief it provides.

The Commission, therefore, is fully empowered under the existing no-action regime to evaluate all relevant factors and conclude that an FBOT is no longer subject to a comprehensive regulatory regime in its home state and, therefore, should be required to register as a U.S. exchange if it wishes to continue to allow direct access to its trading platform from the U.S. By choosing to focus on the qualitative elements of each FBOT's regulatory program and the regulatory regime of its home state regulator, and declining to ascribe particular weight to any particular elements of a program, the Commission is able to consider each request for no-action on its own merits, taking into account the unique and evolving circumstances of each exchange, thereby "foster[ing] the seamless transaction of [international] exchange-traded derivatives business."<sup>1</sup> By providing for prompt access to information from the FBOT and its members, as well as from the FBOT's home state regulator, the Commission assures appropriate customer and market protections, while reserving the authority to modify or even cancel the terms and conditions of no-action relief as the FBOT's business and the markets evolve.

### **The Difficulties of Relying Upon a More Rigid Test**

The Commission has suggested three criteria that could be used in establishing objective thresholds which, if crossed by an FBOT, would require the FBOT to be registered with the Commission: (i) the extent to which volume on the FBOT originates from the U.S.; (ii) the extent of the FBOT's presence in the U.S.; and (iii) the extent to which the FBOT lists for trading contracts whose underlying products are "integral to the U.S. economy." We submit that each of these is significantly flawed.

*Volume Originating from the U.S.* Volume originating from the U.S. should not be a criterion on which the location of an FBOT is determined; the location of an FBOT cannot change simply because a certain percentage of the volume on that exchange comes from a particular jurisdiction.

To begin with, it would be very difficult to devise a volume measure with an acceptable level of precision. Suppose, for example, that the Commission counted only direct access volume from the U.S. since an FBOT would be subject to U.S. registration only to the extent that it allowed direct access to its trading system. At Euronext.liffe, we define direct access volume as orders that are directly transmitted from a member's server via a U.S. trading key. This could include orders that have been routed from the global affiliates of an FCM to the Chicago-based trading infrastructure of the FCM, which would have the effect of overestimating U.S. trading volume. Conversely other FCMs route the orders of their U.S. customers to London, where they are submitted to the trading host via a non-U.S. based trading key. This practice would have the effect of underestimating U.S. trading volume.

Moreover, direct access volume from the U.S. is likely to fluctuate as the result of macroeconomic conditions that expand or contract trading. It would obviously be awkward,

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<sup>1</sup> Final Communiqué on Common Work Program to Facilitate Transatlantic Derivatives Business, issued by Commission and the Committee of European Securities Regulators, June 28, 2005.

to say the least, for U.S. registration to be required because a volume threshold was exceeded for macroeconomic reasons, only to have the volume threshold missed in following years as economic activity slowed. If the FBOT falls below the Commission-established threshold, would the FBOT be allowed to withdraw its registration as a DCM? Would it be required to withdraw its registration?

Trading can also fluctuate in the context of new contracts. LIFFE's experience with the Swapnote futures contract is a perfect example. When LIFFE introduced the contract in 2002, U.S. volume, as measured by trades executed through direct access terminals in the U.S., equaled over 80% of the 71,692 contracts traded. By 2004, the percentage of U.S. volume had dropped to roughly 50%. Today, the contract is no longer trading. Surely, requiring LIFFE to be registered as a DCM based solely on U.S. volume in this one contract would have been the wrong result. (A rule requiring contract by contract registration would have its own set of serious problems—see pp. 5-6, below.)

The Commission might seek to adopt a volume-based measure that defines more precisely volume indigenous to the U.S. Such a standard might include a mixture of what is currently considered direct access, AORS volume, and orders entered via the telephone and other communication devices. The costs of satisfying such a volume standard are potentially substantial, given the likely need to make significant technological adjustments to FCM auto-routing systems as well as exchange trading systems. Further, an FBOT would naturally demand the right to audit the volume count of each of their members since an error in calculation could lead to a demand for U.S. registration. These audits would also be expensive and time intensive.

In sum, both narrowly defined and broadly delineated volume measures are costly to implement, subject to large measurement swings, and unlikely to accurately measure the U.S. activity of an FBOT. Even if the extraordinarily difficult volume measurement issues were overcome, a bright line determination that captures contracts such as the Swapnote described above would be palpably wrong. For these reasons the Commission should not use specific volume measures as a factor in determining whether an FBOT should register as a U.S. exchange.

***Presence in the U.S.*** The presence of certain business operations in the U.S. should not be sufficient to conclude that an FBOT is no longer located outside of the U.S. for purposes of Section 4(a) of the Commodity Exchange Act. As the Commission itself has noted, the “markets for financial services today, which include local and distant customers and intermediaries, increasingly perform portions of their operational and supervisory functions in different jurisdictions.”<sup>2</sup> This is not always by choice. If an exchange is to attract and maintain business, it must, like any service provider, be willing to place essential operations near its “distant customers and intermediaries,” wherever they are located. This means an FBOT may elect to station operational and member liaison personnel in the jurisdictions where its principal members and customers are located or, perhaps, build an operational presence there. For economic reasons, an FBOT may outsource certain back office

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<sup>2</sup> Id.



operations. To the extent these operations are placed in the U.S., the FBOT should not have to worry that it will be required to be registered with the Commission.

***Contracts Integral to U.S. Economy.*** We accept the Commission's premise that the prices of products underlying a limited number of futures contracts traded on FBOTs may have a more immediate and direct impact on the U.S. economy than others. Nonetheless, we do not believe the potential impact on the U.S. economy would be an appropriate criterion for determining whether an FBOT can be considered no longer located outside of the U.S. Clearly, registration would provide the Commission with more direct oversight of the exchange in order to monitor for threats of manipulation and other market problems. However, such direct oversight is unnecessary. The Commission can achieve this same goal—indeed, may only be able to achieve this goal—through robust use of the existing information sharing arrangements and other cooperative efforts.

The Commission's investigation of price manipulation in the copper markets proves this point. In 1998, the Commission initiated and settled a matter against Sumitomo Corporation in which it was alleged that Sumitomo had manipulated the price of copper in 1995 and 1996. This manipulation was accomplished substantially through transactions executed on the London Metal Exchange. In announcing this action, then Chairperson Brooksley Born specifically cited the "unprecedented cooperation" that the Commission had received from the FSA and other regulatory authorities in the United Kingdom. Such cooperative efforts continue today.

Separately, reserving the right to find that the products underlying certain contracts are "integral to the U.S. economy" is far too open-ended. Given the scope and breadth of the U.S. economy, virtually any commodity could be deemed by someone to be integral to the U.S. economy." Who makes this decision? What measurements are used?

#### **The Adverse Consequences of Requiring U.S. Registration of a *Bona Fide* FBOT**

***Requiring registration would not be workable from a regulatory perspective.*** Requiring registration of an FBOT as a U.S. exchange would be highly problematic from the Commission's perspective. Prior to the Commodity Futures Modernization Act, an exchange was designated as a contract market on a contract-by-contract basis, but that is no longer the case. Now, an exchange is designated as a contract market once for all contracts listed for trading. If the Commission were to require an FBOT to become registered as a DCM, the Commission would have to oversee an exchange whose principal operations were located outside the U.S., whose members were largely located outside of the U.S., and whose contracts, for the most part, held little interest for the Commission.

Compounding the confusion, several FBOTs, including LIFFE, trade single stock futures on securities that are not registered under the Securities Exchange Act of 1934 and, therefore, cannot be listed for trading on a U.S. exchange. The Commission would be faced with the difficult choice of either (i) jointly (with the Securities and Exchange Commission) granting an exemption to the FBOT to continue listing such contracts, provoking demands from U.S. exchanges for a level playing field, or (ii) ordering the FBOT to cease trading universal stock futures contracts, causing substantial economic damage to the exchange and denying non-U.S. investors an increasingly popular risk management tool.

On the other hand, were the Commission to choose instead to require an FBOT to be registered only for certain contracts, the consequences would be no less disruptive. The exchange would find itself regulated by the Commission for certain contracts and by the home state regulator for all others; exchange members would be required to comply with the Commission's rules, including rules relating to the segregation of customer funds, for certain contracts and the rules of the home state regulator for that contract and all others; and contracts traded on the same exchange would have to be cleared through two separate clearing organizations.

*Anti-competitive effects—putting the FBOT at a substantial disadvantage.* The Commission's essential mission is to assure the integrity of its own markets and the protection of market participants. At the same time, the Commodity Exchange Act calls on the Commission "to promote responsible innovation and fair competition among boards of trade, other markets and market participants" and, to this end, to "endeavor to take the least anticompetitive means of achieving the objectives of the Act, as well as the policies and purposes of the Act, in issuing any order or adopting any Commission rule or regulation." These two responsibilities are not in conflict, but they do challenge the Commission to strike the right balance.

The Commission has met this challenge well in directing staff to implement the no-action procedure by which an FBOT may allow direct access to its trading system from the U.S.<sup>3</sup> Going further, and requiring an FBOT that has crossed one or more Commission-established thresholds to register with the Commission, however, would place the FBOT at a real competitive disadvantage. The FBOT would be subject to the jurisdiction of two regulators, with potentially conflicting requirements, and would face added costs of complying with such requirements. These costs would be passed on to the FBOT's members and, ultimately, their customers.

In addition, in the absence of further exemptions from the Commission: (i) the FBOT's clearing organization would be required to be registered as a derivative clearing organization; and (ii) the FBOT's members that carry customer accounts would be required to become registered as FCMs, subject to customer segregation requirements, minimum financial requirements, U.S. AML procedures, and mandatory NFA membership (with the concomitant obligation to pay transaction fees on trades executed on the FBOT), even if the member does not carry accounts for U.S. customers. The resulting legal uncertainty (*e.g.*, which customer funds regime and which bankruptcy law would apply) and the substantial costs imposed would be untenable. (If the Commission were to attempt to restructure its regulatory program to accommodate these concerns, the broad scope of these exemptions could undercut, rather than enhance, the Commission's regulatory program.)

No FBOT would willingly commit its resources and take on the significant financial risk of competing with U.S. exchanges for U.S. market participants, if it knew its reward would be the imposition of duplicative, perhaps conflicting, regulatory structures, with the substantial costs such regulation would entail. Even the threat of such action would effectively grant to

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<sup>3</sup> By retaining the no-action regime, the Commission also would avoid the potentially difficult legal questions as to the scope of its statutory authority to regulate foreign exchanges under Section 4 of the Commodity Exchange Act.



U.S. exchanges a monopoly on contracts that may attract significant U.S. interest or whose underlying products may be deemed "integral to the U.S. economy." Competition among exchanges, which serves customers through lower prices and innovative products, would suffer. In light of the Commission's ability to obtain necessary market surveillance and other information through existing information sharing arrangements, we submit that such drastic action is unnecessary.

*The danger of a reciprocal response.* Finally, if the Commission were to make a unilateral determination that an FBOT, by virtue of volume, product, or presence, must register as a U.S. exchange, such action might provoke a reciprocal response by other market regulators, potentially subjecting U.S. exchanges to oversight by foreign regulators if they reached given volume thresholds, offered products deemed to be "integral" to foreign economies, or had some requisite presence in the foreign country. The result could be substantial uncertainty and regulatory disorder as global exchanges found themselves potentially subject to the jurisdiction of two or more regulators and an incompatible set of regulatory requirements.

### **Regulatory Cooperation Is the Best Answer**

In its *Federal Register* release, the Commission stated that, in formulating its regulatory approach, it "will strive to ensure that it neither inhibits cross-border trading nor imposes unnecessary regulatory burdens." We commend those goals and respectfully submit that, to best achieve them, the Commission should maintain the foundation of the current no-action regime. In a time of enormous technological change, which furthers the growth of derivatives trading across international borders, the only reliable way forward is for regulators to cooperate effectively. The introduction of a given contract by an FBOT in the United States might raise particular issues, but there is plenty of room within the existing framework to work cooperatively to handle such cases.

This is the course the Commission first charted in 1987 in adopting its foreign futures and options rules. These rules assure customer protection while promoting responsible innovation and fair competition by reserving to the Commission the authority to exempt from registration and other requirements those persons located outside of the U.S. that are subject to a comparable regulatory program. The Commission has consistently promoted this course in the two decades since. Indeed, it was only a year ago that the Commission joined with Committee of European Securities Regulators in a "joint commitment . . . to facilitate the conduct and supervision of transatlantic derivatives business." It is also a course that Congress has endorsed, instructing the Commission in the Commodity Futures Modernization Act, to "continue to coordinate with foreign regulatory authorities, . . . in order to encourage (1) the facilitation of cross-border transactions through the removal or lessening of any unnecessary legal or practical obstacles; (2) the development of internationally accepted regulatory standards of best practice; (3) the enhancement of international supervisory cooperation and emergency standards; (4) the strengthening of international cooperation for customer and market protection; and (5) improvements in the quality and timeliness of international information sharing."

We urge the Commission to preserve its legacy of international cooperation and coordination by avoiding unilateral action that will only give rise to unforeseen and potentially adverse circumstances.