RECORDS

Chicago Board of Trade

Thomas R. Donovan
President and
Chief Executive Officer

October 7, 1998

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

98-30
(31)

COMMENT

Re: Concept Release on the Placement of a Foreign Board of Trade's Computer Terminals in the United States, 63 Fed. Reg. 39779 (July 24, 1998)("Concept Release")

Dear Ms. Webb:

The Board of Trade of the City of Chicago ("CBOT") welcomes the opportunity to comment on the Concept Release, which raises important issues relating to cross-border and electronic trading. The Commission should be commended for its willingness to address these difficult questions squarely.

The CBOT intends to expand the global reach of its electronic trading system. If a foreign board of trade is subject to burdensome regulation in the United States, we are concerned that foreign regulators will retaliate by hampering our ability to expand our electronic trading system abroad.

The Concept Release describes an approach which generally appears to be consistent with the purpose of CEA §12(g)[1] and with the United States' obligations under the December 1997 Annex on Financial Services ("Annex") to the Fifth Protocol to the General Agreement on Trade in Services ("GATS"). Pursuant to the Annex, in 1999, GATS will apply specifically to "[t]rading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise. . .derivative products including, but not limited to, futures and options." Annex §5(x)(C). This market-opening initiative was led by the United States, which, to date, has minimal or non-existent trade barriers on financial services compared with the rest of the world, and promises to present substantial foreign opportunities to U.S. suppliers of banking, securities, insurance and financial data services. Because of U.S. leadership in negotiating the Annex, other nations will look closely at how the United States implements its own obligations thereunder. Any perceived restriction could reverberate in actions by other signatories across the financial services spectrum. Thus, the Commission must carefully consider any measure that could restrict the provision of cross-border financial services. We believe that the petition procedure set forth in the Concept Release and based on the 1996 DTB No-Action Letter is appropriate under the Annex and should be promulgated as a rule.

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1. The Commission Should Not Grant a Foreign Board of Trade Electronic Access to the United States if Contract Markets Are Denied Electronic Access From the Nation Where That Board of Trade Has Its Core Operations

We oppose the use of regulatory barriers to the introduction of electronic trading systems in any nation, and we believe that regulators should be discouraged from taking such actions. Pursuant to GATS and CEA §12(g), we encourage the Commission to deny a foreign board of trade electronic access from the United States to the extent that contract markets are denied electronic access from that foreign board of trade's nation.

2. Customer Trading Activity Should Be Conducted Through A Registered FCM or Introducing Broker Or A Firm Which Has Been Granted Part 30 Relief.

In fulfilling the obligation to protect customers, the CEA and the Commission's efforts are focused on the relationship between the customer and his intermediaries: the FCM, introducing broker, associated person or Part 30 firm with whom he conducts business. This relationship is subject to the same standards whether the customer trades on a contract market or a foreign board of trade. There is no reason to deviate from this principle in developing rules which would permit foreign boards of trade to be accessed electronically from the United States.

3. When Should Contract Market Designation Be a Condition of Electronic Access from the United States?

CEA §4(a)[1] excepts certain futures contracts "made on or subject to the rules of a board of trade located outside the United States" from the contract market designation requirement. The Concept Release solicits comment on the applicability of this exception to boards of trade who distribute electronic access to their products in the United States. Is there something about electronic access which should cause the board of trade that provides it not to be "located outside the United States?"

The CEA provides a framework for a pragmatic approach to this issue. For the reasons discussed below, we suggest that the Commission focus on the location of the underlying cash market as the principal factor for determining whether a board of trade is "located outside the United States."

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[1]Section 4(a) says in relevant part: "Unless otherwise exempted by the Commission pursuant to subsection (c), it shall be unlawful for any person [to trade a futures contract] (other than a contract which is made on or subject to the rules of a board of trade, exchange or market located outside the United States, its territories or possessions) unless (1) such transaction is conducted on or subject to the rules of a board of trade which has been designated by the Commission as a "contract market" for such commodity (2) such contract is executed or consummated by or through a member of such contract market. . . ".

To set forth our views, it is necessary to distinguish four categories of boards of trade.

First, a board of trade organized under U.S. law whose open outcry trading floor is in the United States is not "located outside the United States." We assume that the Commission would take the view that such a board of trade would be subject to the contract market designation requirement for contracts it sought to make available for trading in the United States by any means.

Second, a board of trade (a) organized under U.S. law, (b) whose principal place of business[2] is in the United States and (c) which makes futures contracts available for trading electronically is not covered by the Concept Release. The criteria under which such a board of trade might be deemed to be "located outside the United States" should not be inconsistent with the rule anticipated by the Concept Release.

Third, a board of trade (a) organized under non-U.S. law (b) whose principal place of business is outside the United States and (c) which does not offer electronic access from the United States is today conclusively presumed to be "located outside the United States."

The Concept Release addresses the fourth category of boards of trade, those (a) which are organized under non-U.S. law (b) whose principal place of business is in a nation other than the United States, and (c) which offer electronic access from the United States. Those boards of trade should be presumed to be "located outside the United States," and the Commission's focus should be on the criteria which would be used to determine whether that presumption has been overcome.

The Commission has suggested that the primary criterion could be the percentage of volume in the relevant contract which was executed electronically from the United States. As other nations reciprocate, one can imagine a kind of regulatory square dance, in which regulators around the world claim and relinquish jurisdiction as volume levels in different contracts rise and fall. In addition, a board of trade could be required to be a contract market for some of its products but not for others. We would also be concerned that market participants might be encouraged to engage in trading from a particular location for the purpose of causing a board of trade to become or not to become subject to the contract market designation requirement. As the CBOT expands its electronic trading network internationally, we strongly discourage the Commission from taking actions which would lead to reciprocal regulation by foreign regulators. We do not believe that it is appropriate for the CBOT to subject itself to increased foreign regulation on the basis of contract volume. None of these results appear to be intended by the Annex. In sum, we respectfully suggest that more stable criteria would

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[2]For purposes of this discussion, we would define an open outcry board of trade's principal place of business as the place where trading occurs (i.e., where the pits are located). An electronic board of trade's principal place of business should be determined by the address identified in its governing documents or regulatory filings, the location of its core operations (the site of its executive offices, surveillance operations and matching engine).

facilitate coordination among regulatory authorities and planning by boards of trade.

We agree with the principle that contract market designation should be required for products which have a significant nexus with the United States. CEA §3 identifies the integrity of cash market prices as the primary purpose of futures regulation.[3] We suggest that the presence of the primary cash market in the United States is the nexus which should support the application of the contract market designation requirement to a foreign board of trade that seeks electronic access from the United States. We ask the Commission to consider the following criteria, which are more stable than volume, and which are already justified in the CEA:

(1) whether the futures contract is based on (a) a security or group or index of securities which is issued in the United States or by an issuer located in the United States or (b) an interest rate paid in the United States on United States dollar loans or deposits;[4]

(2) whether the futures contract permits delivery of a document of title governed by U.S. law;

(3) whether the primary cash market for the underlying commodity is located in the United States; or

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[3]"[F]utures transactions are carried on in large volume by the public generally and by persons engaged in the business of buying and selling commodities and the products and byproducts thereof in interstate commerce. The prices involved in such transactions are generally quoted and disseminated throughout the United States and in foreign countries as a basis for determining the prices to the producer and the consumer of commodities and the products and byproducts thereof and to facilitate the movements thereof in interstate commerce. Such transactions are utilized by shippers, dealers, millers, and others engaged in handling commodities and the products and byproducts thereof in interstate commerce as a means of hedging themselves against possible loss through fluctuations in price. The transactions and prices of commodities on such boards of trade are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed, to the detriment of the producer or the consumer and the persons handling commodities and the products and byproducts thereof in interstate commerce, rendering regulation imperative for the protection of such commerce and the national public interest therein. . ."

[4]This criterion could be formulated along the lines of the Commission's order in Offer and Sale of Foreign Exchange-Traded Options, and Foreign Exchange-Traded Futures Contracts Based on Foreign Stock Indexes and Foreign Government Debt, to Persons Located Outside the United States, 57 Fed. Reg. 36369, CCH Comm. Fut. L. Rep. ¶2702 (August 13, 1992), which permitted FCMs to solicit and accept orders and funds from persons outside the United States, for a foreign board of trade's futures contracts based on foreign stock indexes or foreign government debt that have not been approved for trading in the United States.

(4) whether the delivery and settlement procedure is subject to U.S. law.

4. Petition Procedure

We have no objection to the petition procedure described in the Concept Release. However, it appears that many of the suggested requirements in the proposed request for confirmation are already imposed on Commission registrants and need not be duplicated (i.e., items 2 (certify that it will take reasonable precautions to safeguard access to computer terminals operated by it under the order, 3 (agree to comply with all applicable conditions of the order), 5 (acknowledge that it is subject to the jurisdiction of the Commission and the U.S. with respect to its activities related to the order), 6 (agree to keep books and records in accordance with the Act and the Commission's regulations, if the member or affiliate is registered as an FCM), 8 (if it intends to do customer business, certify that it is or will become registered as an FCM) 9 (litigation history), 10 (notice of material change in structure, status or operations), and 11 (additional information as necessary) .

5. Electronic Order Entry Systems Should be Permitted, but the Means By Which A Customer Enters an Order Electronically Should Not be Considered a "Terminal" and Market Participants and Intermediaries Should Be Free to Decide Whether and How to Use Technology To Satisfy Their Obligations Under the CEA.

Those who are registered as introducing brokers, FCMs or who have Part 30 exemptions should be able to allow their customers to enter orders electronically and to relay those orders automatically into the foreign board of trade's electronic trading system, provided that the orders are subject to credit and position limit checks. Electronic order entry facilities which are not operated by a board of trade are not terminals, but connect to a "terminal" at a registered FCM or a registered introducing broker or a Part 30 firm, from which the order is transmitted to the board of trade, either directly or through a clearing member. A "terminal" should be defined as the point of un-intermediated access to an exchange's trading engine.

In addition, a U.S.-registered FCM which is a member of a foreign board of trade but which has an omnibus account at a clearing member of that foreign board of trade should be permitted to accept orders electronically from its customers.[5]

Human intervention should not be required solely as a means of clarifying jurisdictional boundaries.

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[5]As the Concept Release points out, this would be permitted whether or not the clearing member of the foreign board of trade had received a Part 30 exemption. CFTC Interpretative Letter No. 87-7 [1987-1990 Tr. Binder] Comm. Fut. L. Rep. (CCH) ¶23,972 (Nov. 17, 1987).

6. The Commission Should Retain the Discretion to Decide Whether Its Review of Contract Market Rules Relating to an Arrangement With a Foreign Board of Trade Would Make a Petition By the Foreign Board of Trade Unnecessary.

The Concept Release seeks comment on whether the petition procedure should apply to a foreign board of trade that has a "link" with a contract market.[6] While a "link" can be many things, its principal feature in this context appears to be a network sharing arrangement.

There appear to be three approaches to a foreign board of trade who seeks electronic access from the United States through such a link. The first, which appears to involve unnecessary duplication, is to treat the foreign board of trade's petition and the contract market's rule submission separately.

The second approach is to permit a joint filing by the exchanges. The joint filing would request a single order approving the arrangement (based on the substantive requirements applicable to each exchange).

The third possibility is that under specified circumstances, an arrangement with a contract market would subject the foreign board of trade to a different standard than a foreign board of trade that sought electronic access from the United States by itself. For example, a foreign board of trade from a Part 30 or comparably regulated jurisdiction might be permitted to have electronic access from the United States if it shared a network with a contract market whose rules for trading on that network had been approved by the Commission, or if the contract market agreed to perform certain regulatory responsibilities in the United States (such as the periodic audit of terminal locations described in the Concept Release) for or on behalf of the foreign board of trade.

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[6]In a clearing link, it is possible that the foreign board of trade might not need to file a petition, because its products would not be accessed electronically from the United States. In this respect, the Concept Release mischaracterized the CBOT-LIFFE Link. In an electronic version of the CBOT-LIFFE Link, LIFFE products would not be accessed electronically from the U.S. Rather, a CBOT contract subject to CBOT rules would be executed on a proprietary CBOT network. At the end of the day, open positions in this contract would be novated into LIFFE contracts upon the transfer of those positions from the clearinghouse of CBOT to the clearinghouse of LIFFE. In other words, all activity in the United States would be on or subject to the rules of a contract market, and no "foreign terminals" would be located in the United States.

Accordingly, we believe that there may be circumstances under which it would be appropriate for the Commission to waive the petition procedure or to modify its requirements.

If you have any questions, please contact Terrance K. Livingston, Associate General Counsel, at (312) 347-5322.

Very truly yours,

Thomas R. Donovan