Records 98-37

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CHICAGO MERCANTILE EXCHANGE

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COMMODITY FUTURES TRADING COMMISSION RECEIVED FOR PUBLIC RECORD

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November 17, 1998

Ms. Jean A. Webb, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st St. NW
Washington, DC 20581

COMMENT

VIA FACSIMILE

Re: Comments on *Federal Register* Notice #98-28983, dated October 23, 1998, Regarding the Chicago Mercantile Exchange Russian Ruble Futures Contract. Original CME Submission #98-167

Dear Ms. Webb:

The Commodity Futures Trading Commission ("CFTC" or "Commission") has requested public comments on amendments proposed by the Chicago Mercantile Exchange ("CME" or "Exchange") to the settlement procedure for Russian Ruble futures contracts. The proposed amendments were contained in CME Submission #98-167, dated October 12, 1998 as supplemented by CME Submission #98-195, dated November 6, 1998. The Commission also has requested comments on the CME's intention to apply the proposed amendments to existing positions and the currently listed contract months as well as to newly listed contract months. The CME welcomes the opportunity to respond to the Commission's questions regarding the proposed amendments.

The CME's proposed amendments would adopt procedures developed jointly by the Exchange and the Emerging Market Traders Association ("EMTA") to produce the CME/EMTA Russian Ruble per US Dollar Reference Rate. The CME/EMTA Reference Rate methodology has been endorsed by EMTA, by the International Swaps and Derivatives Association ("ISDA"), and by the Foreign Exchange Committee. Under the CME/EMTA Reference Rate methodology on each Moscow business day two surveys of commercial banks in Moscow are conducted at unannounced random times to determine the Reference Rate for that day. The CME Russian Ruble Final Settlement Price is the reciprocal of the Reference Rate. In addition, the CME's proposed amendments contain backup procedures in the event that two surveys can not be completed on the futures settlement day.

The CME worked closely with EMTA and its members to develop a price-determining methodology that is reflective of activity by commercial banks in the Russian ruble spot market, that is not readily susceptible to manipulation, and that is relatively robust with respect to the sorts of procedural changes that have recently been observed in the spot market. The CME/EMTA Russian Ruble Per US Dollar Reference Rate survey is the result of that effort. EMTA members use the Reference Rate daily to settle currency swaps and Non-Deliverable Forward ("NDF") contracts.

The Exchange employed the CME/EMTA methodology successfully on an emergency basis to settle the October 1998 Russian Ruble futures contract, and received no complaints about that settlement. The conditions that caused that emergency still exist, that is, the continued absence of a MICEX fixing and the continued absence of trading by commercial banks at 11:00 a.m. Moscow time. Therefore, the CME believes that it is both appropriate and imperative to adopt the proposed amendments for the settlement of existing contract months and for the settlement of newly listed contract months. To do otherwise would leave existing position holders in limbo, and would deny the marketplace vital risk management tools.

The Commission asked for comments on three specific topics:

1) THE COMMISSION SPECIFICALLY REQUESTS COMMENT ON WHETHER THE SURVEY WILL RESULT IN A CASH SETTLEMENT PRICE THAT IS REFLECTIVE OF THE UNDERLYING CASH MARKET AND OTHERWISE MEETS THE STANDARDS OF THE COMMISSION'S GUIDELINE NO 1. IN THAT REGARD, THE COMMISSION NOTES THAT THE CME SURVEY PROCEDURE IS DESIGNED TO OBTAIN AN EXCHANGE RATE FOR SAME-DAY SETTLEMENT DURING THE AFTERNOON MICEX SESSION AND THAT TRADING FOR SAME-DAY SETTLEMENT IS NOT CURRENTLY PERMITTED DURING THAT MICEX SESSION.

The Exchange believes that the special MICEX session for exporters and importers, now conducted prior to the daily MICEX session for commercial banks, is a temporary phenomenon. The future financial environment in Russia is unpredictable, and the exact details of the regulations for spot market trading have been in flux. Therefore the proposed amendments have been crafted to be applicable in the current environment, in the environment that existed before August 1998, and in other likely possible environments. That is, the procedures are designed to be applicable as long as there is a market for dollar/ruble transactions between commercial banks in Moscow.

In particular, the CME/EMTA Reference Rate methodology is designed to obtain a best estimate of the exchange rate for same-day transactions even in environments – such as the current temporary one – where direct same-day transactions are not allowed. This is constructed using an exchange rate for next-day settlement, overnight rates in the dollar and ruble money markets, and the usual interest-rate parity formula. The Exchange believes that in the long run same-day transactions between commercial banks will be allowed, and the creation of a synthetic same-day rate will not be necessary. It is important to note that the adjustment from a next-day rate to a same-day rate is typically very small, particularly in comparison to the bid/ask spreads in the cash ruble market and the overnight ruble money market. Therefore, the synthetic same-day rate is a reasonable estimate of the rate at which rubles can be exchanged for dollars for same-day settlement.

The Exchange believes that it has demonstrated that the proposed amendments meet the standards of CFTC Guideline No. 1. That is, the CME/EMTA rate is reflective of cash market transactions. (See above.) It is timely. (The Reference Rate is published daily approximately at the close of the Moscow business day.) It is reliable and accepted by the over-the-counter community. (See above.) It is publicly available and widely disseminated. (It is available on the Internet sites of both the CME and EMTA and on Reuters.) Finally, it is not readily susceptible to manipulation. (See below.)

For existing contracts, given that it is unlikely that the rules currently in place are likely to be applicable, strict adherence to Guideline No. 1 would seem to miss the point. As noted above, there are open positions in the affected contracts, and at some point they must be settled out, whether or not the rate used perfectly passes muster under Guideline No. 1. The Exchange believes that use of the CME/EMTA Reference Rate as is proposed is a fair and reasonable alternative for settling the contracts, under terms reasonably consistent with participants' initial expectations, and should be judged by that standard.

In addition, the Exchange believes that in general it would be a mistake for the Commission to focus solely on a narrow interpretation of

Guideline No. 1 when considering the proposed amendments. The Russian ruble futures contract has undeniably passed the public interest test by performing a valuable hedging and price discovery function during a period of extreme financial crisis for the Russian economy. As that crisis unfolds and is resolved the heightened need for risk management tools will be even more widely (and deeply) recognized. The strictness of application of Guideline No. 1 should be balanced with the risk management needs and alternatives of participants in the affected market. Viewed in this light, the net public benefit of approving the proposed amendments for existing and newly listed Russian Ruble futures contracts is clear. The Commission has clear authority to make such a judgement.

2) THE COMMISSION ALSO REQUESTS COMMENT ON WHETHER THE CME PROCEDURE WILL RESULT IN A CASH SETTLEMENT PRICE THAT IS NOT SUSCEPTIBLE TO MANIPULATION OR DISTORTION IN LIGHT OF THE DEGREE OF LIQUIDITY OF THE RUSSIAN RUBLE MARKET. SPECIFICALLY, WILL THE PROCEDURES USED BY THE CME, INCLUDING SETTING THE CASH SETTLEMENT PRICE BASED ON TWO SURVEYS CONDUCTED AT RANDOM TIMES, TEND TO PREVENT MARKET PARTICIPANTS FROM INFLUENCING THE CASH SETTLEMENT PRICE?

The CME believes that the use of two surveys at unannounced random times during the SELT trading session is a strong deterrent to manipulation. For manipulation to occur under the proposed procedures the currency markets would have to be affected for most of the trading day, at a potentially high cost to the prospective manipulator and for a period of time that would make the effort apparent to market participants. In addition, to the extent that attempts at manipulation disrupt the cash market, they may make it difficult for the Exchange to conduct two complete surveys on the settlement date. In that event, under the proposed procedures, the potential manipulator would have to affect the market on two consecutive days and in the extreme case also on the days leading up to the settlement date. The Exchange believes that these procedures provide a reasonable balance between robustness with respect to attempts at manipulation and hedging precision.

Notwithstanding the preceding paragraph, the Exchange notes that it is widely recognized that sovereign governments have the right to conduct monetary, fiscal, and foreign policy through the direct or indirect influence of market prices, including exchange rates and interest rates. Therefore, it is literally impossible to argue that the Russian Ruble futures contract – or any other financial futures contract – is not susceptible to manipulation in a narrow sense. In this light the most that can be said about the potential for manipulation is that the CME's proposed procedures are designed to be robust and that the Central Bank of Russia closely regulates and monitors the spot market for Russian rubles.

3) FINALLY, IN THE CURRENT ENVIRONMENT, AND GIVEN THE PROPOSED CASH SETTLEMENT PROVISIONS, CAN THE RUSSIAN RUBLE CONTRACT BE USED FOR HEDGING OR PRICE DISCOVERY?

The Exchange has determined that hedgers likely make up a high proportion of the current position holders in the Russian Ruble futures contract. Their likelihood of doing so in the future will depend to a great extent on the Exchange's ability to implement settlement procedures that are acceptable to the marketplace, such as those that have been co-developed with EMTA. The CME/EMTA Reference Rate has proven itself as a price discovery tool for spot transactions. Approval of the proposed amendments for futures would extend that use to forward dates.

Finally, the CME notes that the Commission did not solicit comments on an important issue, namely the CME's intent that the proposed amendments be applied to *newly listed* contract months as well as to those currently listed. (The CME has temporarily suspended the listing of new contract months.) The CME Russian Ruble futures contract provides valuable hedging and price discovery services to the Russian ruble market and will continue to do so for the foreseeable future, if so allowed.

If you or other Commission staff have any questions about this matter please do not hesitate to call me at (312) 930 4574 or Mr. Steven Youngren, Director, Currency Product Development, at (312) 930 4583 or Mr. Eric Wolff, Senior Vice President, Regulatory Affairs, at (312) 930 3255.

Sincerely,

Richard J. McDonald

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Senior Vice President, Research
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cc: Mr. Michael A. Penick, Division of Economic Analysis