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CHICAGO MERCANTILE EXCHANGE

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COMMENT

August 12, 1999

Ms. Jean A. Webb
Office of the Secretariat
COMMODITY FUTURES TRADING COMMISSION
1155 21st Street, N.W.
Washington, D.C.20581

RE: Comments on (1) proposed pilot program for new contract applications and (2) proposed amendments to contract market rule review procedures

Dear Ms. Webb:

The Chicago Mercantile Exchange ("CME" or "Exchange") is pleased to submit these comments on two related rulemaking proposals recently published for comment by the Commission. One proposal would establish a two-year pilot program during which exchanges could list new contracts for trading prior to CFTC approval, although subsequent CFTC review and approval would still be required; it was published in 64 *Federal Register* 40528 (July 27, 1999). The other proposal would amend the CFTC procedures for reviewing exchange rule amendments that relate to the terms and conditions of previously approved contracts; it was published in 64 *Federal Register* 38159 (July 15, 1999).

The CME agrees that the CFTC review process needs to be streamlined because approval of new exchange contracts and rule amendments can be delayed for a significant time under the current process. However, as discussed below, the CFTC proposals do not adequately solve that problem. In our view, the CFTC proposals represent a modest step in the right direction, but they do not eliminate the need for more significant relief for U.S. exchanges as recently requested by the Petition for Exemption submitted jointly by the CME, Chicago Board of Trade and New York Mercantile Exchange.

I. Proposed Pilot Program for New Contract Applications

This proposal represents a significant departure from the CFTC's previous position that it must approve all contract market designation applications before a new contract can start trading. The CME applauds the Commission for taking an important first step in granting meaningful regulatory relief to the U.S. exchanges. The CME also supports the Commission's use of its exemptive authority under Section 4(c) of the Commodity Exchange Act (the "Act")[1] to grant such relief. However, the proposal contains a number of restrictions that limit its usefulness:

- It is being established as a two-year pilot program, with no assurance that it will be continued or expanded when it is due to expire.

- A participating exchange must file with the CFTC an application for contract market designation within 45 days of initially listing the new contract for trading. CFTC approval of new contracts under existing regulations and guidelines is still required, and it is possible that the CFTC could disapprove a new contract or require its terms to be amended.[2] That possibility is likely to discourage market participants from trading the new contract.

- The exchange may not list any contract months for trading that are more than one year out until the CFTC approves the new contract.

- The proposal does not change the legal standards for CFTC review of new contracts. On occasion in the past, the CFTC has refused to approve a new contract when its judgment as to how the contract should be designed differed from that of the exchange creating the contract. The CME believes that the CFTC should not disapprove a new contract under the new procedure in the absence of clear evidence that the contract was causing fraud, manipulation or danger to the financial integrity of the market.

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[1] As a technical matter, the CME believes that the Commission can rely upon Section 4(c)(1) rather than Section 4(c)(2) to support this exemptive relief because the new contracts listed for trading would be subject to the rules of an exchange which has been designated as a contract market and the exchange would be subject to all of the self-regulatory responsibilities of a designated contract market with respect to the trading of such new contracts. However, if the Commission chooses to proceed under Section 4(c)(2), we believe that the Commission was correct in finding that all traders of contracts listed on designated exchanges are "appropriate persons," that the proposed rule is consistent with the public interest, and that it will not have an adverse effect on the Commission's ability to discharge its regulatory responsibilities under the Act.

[2] The CFTC should be extremely reluctant to take such action with respect to contract months with open positions. See, for example, Section 5a(a)(10) of Act, which provides that a CFTC order to change a contract's delivery points shall not apply to contract months with open positions.

The restrictions contained in the CFTC's proposed pilot program appear to be based on the premise that in-depth CFTC review of new contract applications serves an important public purpose by providing an opportunity for public comment and by improving contract design. The CME disagrees with that premise. Although we appreciate the importance of properly designed contract terms, and we agree that it is extremely important to consult with commercial users of the market in order to design appropriate contract terms, CFTC review of new contract applications is not necessary to accomplish those objectives. When the CME is developing a new contract, it talks with market users at length and takes great care in designing contract terms so that they will be acceptable to the commercial users. The CME has a strong business interest in designing its contracts so that they are not readily susceptible to manipulation, knowing that a contract that can be easily manipulated will not be attractive to market users.

The examples cited by the CFTC in support of its position that CFTC review of new contract applications provides important public benefits are unpersuasive. In one example, market participants opposed a proposed potato contract's terms in public comments filed with the CFTC because the proposed discounts for non-par varieties and locations did not conform to cash market practices. If that contract had been allowed to start trading under its original terms, market participants presumably would not have used it because of its flawed contract design. In that event, either the listing exchange would amend the contract terms, or another exchange would introduce a potato contract with an improved design. There is no evidence that any public harm would have occurred by letting the exchange list and try to promote a poorly designed product.

As a second example, the CFTC pointed to an instance where a smaller exchange accepted the CFTC staff's suggestion on an appropriate means of constructing an index with a large number of inactively traded stocks. Although the CME does not object to the CFTC staff assisting smaller exchanges in designing new products, we believe that this example provides no justification for asserting that CFTC review is needed for all new contract applications submitted by all exchanges.

In addition to the above general comments, the CME would also like to comment on some of the specific provisions of proposed CFTC Regulation 5.3. Section 5.3(a)(i) requires that the board of trade must already be designated as a contract market in at least one other contract before it can take advantage of the pilot program for predesignation listing of new contracts. As noted in the Commission's release, start-up exchanges are not appropriate candidates for the proposed pilot program because the initial designation of a board of trade as a contract market entails a more lengthy review and analysis of its trading and clearing systems and its self-regulatory programs. This restriction makes sense, and we support it.

Section 5.3(b) provides that the board of trade "may not list for trading delivery months or option expirations for more than one year at any time prior to the contract's designation as a contract market." We believe that we understand what this provision means, but we offer the following example for the sake of clarification. Assume that an exchange lists a new contract under the pilot program in February 2000 that has delivery months on a quarterly cycle (March, June, September and December). When the contract starts trading in February 2000, the first four delivery months can be listed for trading. Assume further that CFTC review of this contract is not completed when the March 2000 delivery date occurs. It is our understanding that the exchange could then list the March 2001 delivery month for trading even though that date is more than one year after the initial listing of the new contract. In other words, the one-year period keeps rolling over as time passes until the application for contract market designation is approved, at which time the one-year restriction is eliminated. Please let us know if our understanding is correct.

Section 5.3(c) provides that an exchange participating in the pilot program must file an application for contract market designation within 45 days of listing a new contract. It is possible that the CFTC could disapprove the contract or require its terms to be amended, and this possibility is likely to discourage market participants from trading the new contract. The CME believes that this problem can be mitigated by providing that any such action by the CFTC would be taken only as a last resort and only if the CFTC determines that the contract was causing fraud, manipulation or danger to the financial integrity of the market.

Section 5.3(e)(ii) provides that the proposed pilot program is not available for a contract "that is the same or substantially the same as one for which an application for contract market designation ... was filed for Commission approval prior to being listed for trading while the application is pending before the Commission." The stated reason for this restriction is to protect an exchange that has submitted a designation application to the CFTC under regular or fast track procedures from having a second exchange list a similar contract faster by using the pilot procedure. If that is the intent of this restriction, then we believe that the language of the proposed regulation should be modified to make it clear that an exchange is not prevented from using the pilot procedure to expedite listing a new contract even though it had originally submitted the same contract to the CFTC for pre-approval under the regular or fast track procedures. In other words, the exchange originating a new contract should be allowed to use the pilot procedure at any stage before or during CFTC review of its application.

When one exchange attempts to use the pilot procedure to beat another exchange to market with a similar new contract, the CFTC describes this as "an unwarranted competitive use of the proposed rule." However, we can envision the restriction in the proposed rule being used for competitive gamesmanship. For example, assume that two exchanges are each developing similar new products, but one exchange fears that the other will be ready to start trading it 30 days sooner. In that situation, the exchange that is behind could file an application for contract market designation under the regular or fast track procedures, thereby preventing the exchange that is ready to list the new product sooner from using the pilot procedure to exploit its timing advantage. On balance, we believe that this proposed restriction has the potential to do more harm than good and thus should be eliminated.

In conclusion, the CME believes that the proposed pilot program should be made permanent and that the restrictions noted above that limit its usefulness should be removed.

II. Proposed Amendments to Contract Market Rule Review Procedures

In recent years, the CFTC has adopted expedited procedures for reviewing certain types of exchange amendments to contract terms. The current proposal modifies those procedures in minor ways. The proposal expands the categories of rule amendments eligible for automatic approval to include routine changes to an index (other than a stock index) compiled by a third party; typographical, renumbering and other types of non-material changes; certain changes to trading hours and trading months; and certain changes to discretionary option strike prices. Although the CME welcomes any movement in the direction of eliminating CFTC pre-approval of rule changes, the categories being proposed for automatic approval are so limited that only rule changes of trivial importance will be affected.

All other amendments to contract terms and conditions will continue to require some degree of CFTC review before they can become effective. Depending on the nature of the amendment and whether the CFTC deems that the amendment raises novel or complex issues, the review period can be three days, ten days, 45 days, 75 days or 180 days.

The CFTC release cites some statistics in support of the proposition that the agency processes most rule changes promptly. Out of 290 rule changes submitted in fiscal year 1998, 195 were approved immediately or within ten days of receipt. However, given that most of those rule changes were nonsubstantive in nature, one would expect a fast review. (Indeed, we question why nonsubstantive rule changes need to be reviewed by the CFTC at all.) In our view, the statistics for the 131 rule changes approved under the regular review procedure are more revealing. The approval times for those rule changes were as follows:

Review Time	No. of Submissions	% of Submissions
10 days or less	36	27%
11-30 days	65	50%
31-60 days	21	16%
61 days or more	9	7%

Relatively few (27%) of these rule changes were approved in ten days or less, and almost the same number (23%) took longer than 30 days to be approved. Even more telling is the fact that nine rule changes were not approved until more than 60 days had passed.

The CME and other U.S. exchanges face growing competition from OTC and foreign markets. The inability of U.S. exchanges to amend their rules promptly to meet a competitive threat places them at a severe disadvantage to their less-regulated competitors. For the following reasons, the current CFTC proposal does not grant adequate relief:

- In many cases, the CFTC review process takes too long. A U.S. exchange cannot afford to wait 180 days, 75 days, or even 45 days to implement rule changes that are needed to meet a competitive threat, perhaps coming from a competitor that can alter its rules at will.

- The legal standards for CFTC review are too vague. Exchanges should be allowed to implement rule changes promptly unless the CFTC finds that the rule is likely to cause fraud, render trading readily susceptible to manipulation, or threaten the financial integrity of the market.

- The current proposal addresses only amendments to contract terms and conditions; it does nothing to shorten the review process for other types of rule changes, such as rules seeking to implement new methods of trading.

The CME believes that the Commission needs to take bold action to radically rethink its process for reviewing contract market rule changes. The Commission took a large step in the right direction in the proposed pilot program discussed above which would allow exchanges to list new contracts for trading prior to CFTC approval. Why not adopt the same approach for rule changes? Under such an approach, exchange rule changes could be put into effect immediately (or a short time after giving notice to the CFTC), and such rules could not be disapproved unless the Commission finds that the rule is likely to cause fraud, render trading readily susceptible to manipulation or threaten the financial integrity of the market.

However, instead of proposing meaningful reform, the CFTC proposal merely continues the CFTC practice of micromanaging business issues that have nothing to do with fraud, manipulation or financial integrity. For example, the CFTC staff has a bias in favor of small tick sizes and large price limits. Accordingly, the proposed regulation would allow an exchange to decrease (but not to increase) a contract's tick size, or to enlarge (but not to reduce) a contract's price limit, under the expedited three-day review process. Tick sizes and price limits are issues that should be decided by the exchange listing the contract because they affect how well the contract will trade. They do not implicate any regulatory concerns that are serious enough to justify requiring such issues to be pre-approved by the Commission.

A good example of CFTC micromanagement of business issues occurred when the CME decided to adjust the tick size of its E-Mini S&P 500 futures contract from .10 index points to .25 index points. The Exchange submitted a Regulation 1.41(b) Fast Track submission to the CFTC on August 4, 1997. This amendment was made before trading in the new contract began, thereby eliminating any concern over how open positions might be affected. Nevertheless, the CFTC decided that this issue was important enough to justify publishing an invitation for comments in the *Federal Register*. After a short comment period, the Commission approved the rule amendment on September 8, 1997, some 35 days after it had been submitted. This is the sort of issue that should be decided by an exchange's business judgment. If the exchange chooses a tick size that is too large, market participants will be discouraged from trading. If the exchange chooses a tick size that is too small, the market price will fluctuate from tick to tick very rapidly, making it more difficult to execute trades at the bid-ask quotes that are publicly displayed. The CME's business judgment was validated by the phenomenal success of the E-Mini S&P 500 contract. CFTC review of the tick size served no purpose other than to jeopardize the scheduled launch of that exciting new product.

One section of the proposed regulation deserves special comment because it actually increases the time period for CFTC review. Under proposed Regulation 1.41(b)(3), certain types of rule changes shall be deemed approved by the Commission ten business days after receipt, including certain types of rule changes that currently require only ten calendar days for review. See Regulations 1.41(m) (contract terms established by third parties) and 1.41(t) (financial standards for delivery facilities). At a minimum, we believe that the time period specified in proposed Regulation 1.41(b)(3) should be ten calendar days, rather than ten business days.

III. The CFTC Should Approve the U.S. Exchanges' Petition for Exemption

The CME, CBOT and NYMEX recently submitted a Petition for Exemption to the CFTC. Those exchanges requested regulatory relief in the following areas in order to compete on equal terms with foreign boards of trade that are able to offer competing products via direct electronic access to persons in the U.S.:

1. The exchanges should be allowed to list new contracts for trading without CFTC pre-approval.

2. The exchanges should be allowed to adopt substantive new rules or rule changes upon submitting them to the CFTC ten days in advance of their effective date. (Nonsubstantive rule changes should be allowed to go into effect immediately without CFTC review.)

3. The exchanges should be allowed to implement trading rules and procedures comparable to those of a competing foreign exchange, provided that such rules and procedures apply only to the contracts that are subject to direct competition from the foreign exchange.

The Global Markets Advisory Committee's Ad Hoc Subcommittee on Regulatory Parity recently issued a report making similar recommendations.

The current U.S. regulatory model which requires advance CFTC review of all substantive rule changes of exchanges makes it increasingly difficult for U.S. exchanges to compete against less-regulated OTC and foreign markets. An alternative -- and we believe more desirable -- model for regulatory oversight of financial markets is provided by the U.K. Financial Services Act. Exchanges in the U.K. such as the London International Financial Futures and Options Exchange ("LIFFE") can adopt new contracts and new rules, and can amend existing contracts and rules, without any prior approval from their government regulator. LIFFE has been very successful at developing new contracts and new trading rules, and it also has the reputation of being a very well-regulated exchange. There is no reason to believe that the high regulatory standards of the U.S. exchanges would suffer if they operated under a regulatory regime in which they could adopt new rules and new contracts without prior CFTC review and approval.

The CFTC's Division of Trading and Markets recently issued a no-action letter allowing LIFFE to place trading terminals in the U.S. without being designated as a contract market. The no-action letter specifically noted that LIFFE is not subject to a pre-approval requirement when it wishes to list new contracts or amend its rules; instead, LIFFE is required to report changes in its rules and procedures to its regulator within seven days of such amendments becoming effective. Nonetheless, the Division of Trading and Markets concluded that LIFFE and its market participants "are subject to oversight in the United Kingdom by a legitimate regulatory authority that is responsible for ensuring their compliance with an extensive regulatory regime."[3] Since the CFTC has found that the U.K. model provides an appropriate level of regulatory oversight of an exchange that offers trading terminals in the U.S., we believe that the same level of regulatory oversight should be acceptable for U.S. exchanges.

In conclusion, we urge the Commission to use its exemptive authority under Section 4(c) of the Act to grant the relief requested in the Petition for Exemption submitted by the U.S. exchanges.

Respectfully submitted,

M. Scott Gordon

MSG/df 4434

cc: Chairman William J. Rainer
Commissioner Barbara P. Holum
Commissioner David D. Spears
Commissioner James E. Newsome
Commissioner Thomas J. Erickson

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[3] Letter dated July 23, 1999, from I. Michael Greenberger, Director, Division of Trading and Markets, to Arthur W. Hahn, counsel for LIFFE, at page 24.