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VIA ELECTRONIC MAIL

Ms. Jean Webb
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Center, 8th Floor
1155 21st Street, N.W.
Washington, D.C. 20581

Re: U.S. Futures Exchange, L.L.C. Application for Contract Market Designation

Dear Ms. Webb:

Chicago Mercantile Exchange Inc. ("CME") welcomes the opportunity to comment upon the U.S. Futures Exchange, L.L.C.'s ("Eurex U.S.") Application for Contract Market Designation (the "Application").[1] CME invented financial futures contracts more than 30 years ago and is currently the largest futures exchange in the United States and the largest derivatives clearing organization in the world. CME is also the only demutualized and publicly traded financial exchange in the United States. As an international marketplace, CME brings together buyers and sellers on its trading floors and GLOBEX® electronic trading platform. CME offers futures and options on futures primarily in four product areas: interest rates, stock indexes, foreign exchange and commodities. Nearly one-half of all trading activity in our products is fully automated and transacted through the GLOBEX electronic trading platform. Our products compete with products traded in the over-the-counter derivatives, equity index options and cash securities markets, as well as competing futures and options markets around the globe. CME moved about $1.5 billion per day in settlement payments in the first three quarters of 2003 and managed $29.6 billion in collateral deposits at September 30, 2003.

Eurex U.S. submitted its Application pursuant to Part 38 of the Commodity Futures Trading Commission's ("CFTC" or "Commission") regulations, for fast track review, on September 16, 2003. The Commission originally set a 15-day comment period ending October 1, 2003, which was extended to October 16, 2003. The Commission initially announced an intention to complete its review of the Application within the 60-day fast track review period

[1] As used herein, the term "Application" includes all the publicly-available exhibits that USFEX has submitted to the Commission in support of its application, unless the context requires otherwise. All terms capitalized herein and not otherwise defined shall have the meaning ascribed to them in USFEX's Rules.

provided in CFTC Regulation Section 38.3. On October 14, 2003, the Commission decided to remove the Application from the fast track approval process. We commend the Commission's decision, which will allow for a more thorough review of the Application. CFTC Regulations reserve fast track approval for applications that: 1) are complete; 2) are open for inspection; 3) self evidently demonstrate compliance with the Designation Criteria and Core Principles; and 4) raise no novel issues. Eurex U.S.'s Application failed each and every one of these criteria, and was clearly inappropriate for the Commission's fast track approval.

Eurex U.S.'s Application describes a plain vanilla exchange with no futures or options contracts and no regulatory processes. Upon receiving designation as a contract market, it will then proceed to self-certify the rules that implement its true business plan with no further review from the Commission or other interested parties. Eurex U.S. seeks all of the benefits of CFTC designation by describing a "black box" branch office of Eurex Frankfurt, A.G. ("Eurex Frankfurt"), in which *all* of Eurex U.S.'s critical clearing, operational and regulatory functions are outsourced to third parties, one of which, Eurex U.S.'s ultimate parent Eurex Frankfurt, is based in Germany and not subject to the Act, and another, the National Futures Association, has not even formally agreed to perform the outsourced functions. Worse still, Eurex U.S. omitted from its application all of the critical, material information respecting exchange operations despite the fact that it is using such information to offer memberships and solicit market makers. Eurex U.S. has not even included basic information respecting the contracts it intends to list, its fees and its programs to create the appearance of liquidity.

Under the Act, the Commission is charged with determining whether approval of Eurex U.S.'s Application is consistent with the requirements of the Act. CME believes that the Commission should not approve the Application until: 1) CME and other interested parties have been provided with adequate documentation to critically analyze and constructively comment upon Eurex U.S.'s proposal; and 2) Eurex U.S. amends its operating, compliance, surveillance and disciplinary procedures and files an application demonstrating that it meets the Designation Criteria and Core Principles required for designated contract market status.

I. Eurex U.S.'s Proposal is Materially Deficient.

Eurex U.S.'s Application consists of 20 documents. The documents that are key to understanding whether Eurex U.S. satisfies the criteria for designation were labeled confidential by it and are not being released for public comment.[2] The suppressed documents deal with the most basic aspects of the operation and regulation of the proposed exchange, including the agreements that govern Eurex U.S.'s proposed clearing, performance and regulatory arrangements and capabilities—in other words, the heart of Eurex U.S.'s proposal.

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[2] The only documents that have been released to the public are: 1) a chart prepared by USFEX that purports to demonstrate compliance with the Commission's Core Principles (the "Chart"); 2) USFEX's Certificate of Formation; 3) USFEX's Limited Liability Agreement and Bylaws (the "Bylaws"); 4) USFEX's Exchange Rules (the "Rules"); and 5) membership applications and systems-related manuals.

This wholesale suppression of information violates the Act (Act §6). An applicant may not demand confidential treatment for an entire document that includes a few snippets of confidential information that may easily be redacted. Eurex U.S. failed to justify its demand for confidential treatment with the required "reasonable justification." This is clearly demonstrated by the Commission's decision, subsequent to CME's September 16, 2003, Freedom of Information Act ("FOIA") request, to release a portion of Eurex U.S.'s documents that were previously identified as confidential.

As explained in greater detail below, the applicant has not offered any information to demonstrate that its complete delegation of regulatory functions satisfies either Designation Criterion 2 or 3. An application that merely states that NFA and/or Eurex Frankfurt will perform such functions without any descriptions of the specific resources that NFA will bring to bear, or whether NFA has the relevant skill and expertise to do so, does not satisfy the requirements under the Act. As demonstrated below, many of the most important rules respecting the fairness of markets to customers are facially inadequate, incomplete or ambiguous. The Application includes no explanation as to how those rules can possibly comply with key Designation Criteria.

CME believes public comment on all the documentation relating to the Application is critical to the Commission's informed assessment of Eurex U.S.'s proposal. CME also believes that Eurex U.S. is required to make the information public pursuant to Designation Criterion 7 of the Act[3] and Core Principle 7 of the Act,[4] both of which are designed to ensure that the public has broad access to a proposed exchange's rules and regulations. To date, however, CME has not received the core information upon which the Application rests.

We believe that the Application is inadequate for public comment or Commission approval because it does not describe many of the most basic aspects of the operation and regulation of the proposed exchange, and fails to meet the designation criteria of the Act. The Commission should require Eurex U.S. to supplement or amend its Application to fill in the gaping holes and request the Commission to provide commentators another opportunity to submit comments after the documentation is made available to the public.

II. The Application Does Not Demonstrate Compliance With The Act.

The Application is materially inconsistent with the Act, in that it is replete with deficiencies and inconsistencies, and raises important questions concerning Commission policy

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[3] Designation Criterion 7 of the Act provides that: "The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade."

[4] Core Principle 7 of the Act provides that: "The board of trade shall make available to market authorities, market participants, and the public information concerning—(A) the terms and conditions of the contracts of the contract market; and (B) the mechanisms for executing transactions on or through the facilities of the contract market."

that must be answered before Eurex U.S. is licensed for business in this country. For the reasons discussed below, the Commission should not approve the Application.

A. Foreign Ownership and Control of Eurex U.S.

CME welcomes fair competition from both domestic and foreign exchanges. Indeed, Eurex has already been operating in the U.S. since 1998 by offering its products to U.S. investors and Eurex itself claims that approximately 25% of its business is derived from the U.S. Therefore, CME's concerns do not relate to competition from foreign exchanges but rather, the important regulatory policy issues raised by Eurex's efforts to further expand its U.S. operations by becoming a U.S. designated contract market. For example, we are concerned that: 1) a foreign exchange, such as Eurex Frankfurt, that generates profits under a system that protects it from significant competition will use those profits to subsidize efforts to capture U.S. markets in a manner that creates an uneven playing field for other industry participants; 2) Eurex U.S.'s market entry may (as discussed below) be by means of abusive practices such as payment for order flow—a practice that may be tolerated in foreign jurisdictions, but is not acceptable in the U.S. futures markets; 3) foreign ownership of Eurex U.S. could impair the effectiveness of the Commission's emergency authority—especially where the emergency results from the governmental action in the jurisdiction of the foreign owner; and 4) restrictions on trading by an exchange's officers or directors are of limited use when such persons are foreign nationals beyond the reach of U.S. jurisdiction. Indeed, neither the Act nor existing Commission regulations even require a foreign company with 100% ownership of a U.S. exchange to meet any qualification requirements.

In this respect, we also note that Eurex Frankfurt has significant control over Eurex U.S.'s operations. According to Section 5.2 of the Bylaws, Eurex U.S. will have only "one Director"—a Director that was not only hired and appointed by Eurex Frankfurt, but is apparently subject to removal by Eurex Frankfurt. Under these Bylaws, the sole Director of the Board, appears to have been granted immense authority over every aspect of operating the exchange without the involvement of others, including the ability to establish policy, make and amend rules, determine the contracts traded and margin requirements therefor, and oversee trading, regulatory and clearing operations for Eurex U.S. This is clearly a fiction, with this Director having neither actual nor apparent total authority to individually operate Eurex U.S.'s entire enterprise. Moreover, the Commission will not have jurisdiction over the true controlling persons of Eurex U.S. Without such jurisdiction, the Commission will not have the ability to prevent the Director from making decisions that may negatively affect the market, its participants and investors. For example, the Director could shift funding away from the regulatory functions of the exchange or impose other market changes that undermine the quality of the market or adversely impact market users.

Given the amount of influence that Eurex Frankfurt will have over the Director, Eurex Frankfurt should be accountable to the Commission. Based upon the Application and the lack of CFTC rules and standards in this area, however, it appears that Eurex Frankfurt is not. The Commission should not approve a contract market in a circumstance where, as here, the entity

that controls the contract market is beyond the Commission's regulatory reach until appropriate rules and standards have been developed.[5]

For example, the Board of Governors of the Federal Reserve System (the "FRB") and federal and state banking agencies have implemented a rigorous approach with respect to the admittance of foreign banking organizations into the U.S. banking system through the purchase or establishment of U.S. banks or branches or agencies of the foreign bank, and the subsequent supervision of the U.S. activities of these foreign entities. Generally, under the FRB's Regulation K, which implements relevant provisions of the Bank Holding Company Act of 1956 and the International Banking Act ("IBA"), 12 USC 3105 et seq., a U.S. branch or agency or acquisition of a foreign bank will not be approved by the FRB until it has determined that the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor and that the supervisor shares material information regarding the foreign banking organization with other supervisory authorities. In addition, the FRB carefully analyzes the financial and managerial resources of the foreign bank and ensures that the foreign bank has provided assurances that it will make available to the FRB all such information on its operations and activities that the FRB deems necessary to determine and enforce compliance with relevant U.S. banking laws. The FRB also considers whether the foreign bank has adopted and implemented measures to detect money laundering, and whether the foreign bank and its affiliates are in compliance with U.S. law.

In stark contrast to the FRB's procedures set forth above, the Commission does not appear to conduct on-going reviews of the regulatory structure in Germany to determine if there is a comprehensive supervisory or regulatory regime in place that can adequately oversee the operations of Eurex Frankfurt or Eurex U.S. If it did, the Commission is likely to find little solace in Eurex's self-regulatory efforts. For example, as the exchange that trades futures and options on German government debt, Eurex has been at the center of several squeezes involving German debt. The most widely-reported large scale squeeze allegedly occurred in March, 2001, when Deutsche Bank reportedly cornered the cheapest-to-deliver note for the Bobl (mid-term) contract maturing in March, 2001, which resulted in a significant gain to Deutsche Bank, but large losses to traders with short positions. Eurex's response was muted. Even though the allegation concerned market manipulation, Eurex merely issued a private reprimand to Deutsche Bank. It does not appear that the German government took any action against Deutsche Bank or in favor of the traders that lost money. [6]

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[5] The fact that Nasdaq-LIFFE, or NQLX, has been operating since July as a 100% wholly subsidiary of Euronext LIFFE highlights the urgent need for the Commission to develop appropriate rules and standards to ensure that the Commission can fulfill its statutory obligations under the Commodity Exchange Act.

[6] *See e.g.*, J. Politi, *"Squeeze" Reprimand Considered Lenient*, Financial Times, May, 31, 2002; N. de Teran, *Eurex Changes Rules After DB Upset*, Financial News, October 22, 2001. Also, similar squeezes, though less widely reported, have also allegedly occurred with respect to the Bund and Schatz contracts, the most notable cases being in September of 1998 (Bund), June of 1999 (Bund) and March of 2002 (Schatz). *See e.g.*, S. Jeanneau and R. Scott, BIS Quarterly Review, June 2001; J. Politi and A. Van Duyn, *German Market Feels the Schatz Squeeze*, Financial Times, April 19, 2002.

The Securities and Exchange Commission ("SEC") has also considered these same jurisdictional issues and concluded that it must have jurisdiction over a non-regulated entity that controls a facility of a United States securities exchange. Therefore, as a condition of regulatory approval of such control, the SEC required the non-regulated entity that owned the facility to agree to SEC jurisdiction over its officers and directors.[7] The non-regulated entity in this instance was a U.S. limited liability company. It is our understanding that the SEC is now carefully examining these issues in the context of foreign ownership of registered U.S. securities exchanges.

CME believes that this should be an important concern for the Commission and the Commission should therefore require additional information from Eurex and the German regulatory authorities before considering the Application. This issue is of paramount importance since the sole Director of the Eurex U.S. Board is hired and appointed by Eurex Frankfurt. CME urges the Commission to determine whether it will be able to assess penalties against Eurex Frankfurt, the foreign domiciled parent of Eurex U.S. as the FRB does in the international banking arena. In addition, none of the documentation made public to date indicates that the Commission has reviewed whether Eurex Frankfurt has anti-money laundering rules in place or whether Eurex Frankfurt has agreed to provide necessary financial and regulatory information to the Commission as such information may relate to the activities of Eurex U.S. These types of safeguards are followed by the FRB with respect to foreign banks and should be applied by the Commission prior to approving the application of Eurex U.S.

B. Improper Payment For Order Flow Practices.

In a Eurex U.S. report entitled "Global Access to the World's Benchmark Derivatives," dated September, 2003 (the "Report") [8], Eurex U.S. provides that a "revenue rebate plan for the US Treasury derivative products will run for the first two years of Eurex U.S. operations[,]" providing "50% of trading fee revenues on the first year of operation [and] 25% of trading fee revenues on the second year of operation[.]"[9] Notably, "[r]evenue will be refunded on a monthly basis to Top 10 firms in agency and Top 10 in prop/market making activity, in proportion to their volume."[10] This rebate plan has not been disclosed to the Commission in the Application filed by Eurex U.S.

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[7] See Rule 14 of the Pacific Exchange ("All officers and directors of Archipelago Holdings, L.L.C., shall be deemed to be officers and directors of [Pacific Exchange] and PCX Equities for purposes of and subject to oversight pursuant to the Securities Exchange Act.

[8] *See* Report at 10. The relevant page of the Report is attached as Attachment A.

[9] *Id*.

[10] *Id*.

Eurex U.S.'s proposed plan to buy order flow is not only improper, but unprecedented in the U.S. futures markets. While the Commission has not previously considered payment for order flow programs, the Securities and Exchange Commission (the "SEC") and its staff have long been critical of such programs. In November 1999, SEC Chairman Arthur Levitt stated at a Securities Industry Association Conference that, "I worry that best execution may be compromised by payment for order flow, internalization and certain other practices that can present conflicts between the interests of brokers and their customers."[11] In addition, in January, 2003, former SEC Chairman Harvey Pitt sent a letter to the five U.S. options exchanges, urging them voluntarily to abolish exchange-sponsored plans that encourage payment for order flow (and internalization). In the letter to the exchanges, Chairman Pitt stated: "I am seriously concerned that economic inducements to order-flow providers and internalization by member firms create serious conflicts of interest that can compromise a broker's fiduciary obligation to achieve best execution of its customer orders."[12]

We believe that the Commission should not permit payment for order flow programs to infiltrate the U.S. futures markets. Most importantly, payment for order flow programs are inconsistent with a broker's duty to its customers. Brokers in the U.S. futures markets owe a fiduciary duty to their customers but are not subject to a best execution rule. That duty would be violated if brokers were entitled to very large payments from Eurex U.S. if they won the monthly contest for sending customer orders to that market. No amount of boiler plate disclosure can cure that form of breach of fiduciary duty. Moreover, if permitted in the U.S. futures markets, such programs would likely weaken the self-regulatory functions of the exchanges administering these programs, because it puts the exchange in the position of undue involvement in the details of payment for order flow mechanics, when the exchange should be focused on ensuring that such arrangements do not compromise the responsibilities of market makers to their customers.

Eurex U.S.'s program is a most pernicious form of payment for order flow because Eurex U.S. is not only prepared to buy order flow (rather than compete for it), but has created a "scheme" with respect to U.S. Treasury futures in which only the top 10 firms will receive rebates—an artifice that will only encourage all market makers to blindly funnel orders to Eurex

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[11] Speech by Arthur Levitt, Chairman, SEC, to Securities Industry Association (November 4, 1999).

[12] Letter from Harvey Pitt, Chairman, SEC, to Meyer Frucher, Chairman, Phlx (Jan. 24, 2003); *see also,* SEC Chairman Arthur Levitt, "Toward Markets Driven By Footsteps," Remarks at 67th Annual Conference and Business Meeting of Security Traders Association (Oct. 12, 2000); SEC Special Study: Payment for Order Flow and Internalization in the Options Markets (December, 2000).

Moreover, in response to Chairman Pitt's letter, the Philadelphia Stock Exchange ("Phlx") moved to challenge payment for order flow and internalization practices. On February 4, 2003, the Phlx submitted a petition to the SEC, formally requesting the SEC to ban exchange-sponsored payment for order flow programs. In its rulemaking petition, the Phlx stated that it "strongly agree[s] with Chairman Pitt that exchange-sponsored payment for order flow programs are deleterious to the options markets," and that the practice has "put unfair burdens on market makers and place exchanges . . . in the uncomfortable position of administering payment arrangements between specialists and order flow providers." *See* Phlx Petition for Rulemaking, Options Exchange Payment for Order Flow Programs (Feb. 3, 2003). To date, the SEC has not acted on Phlx's petition.

U.S. in hopes of scoring a large rebate. In promoting the interests of market makers, Eurex U.S.'s program relegates the interests of customers to an afterthought. (Indeed, nowhere in the 28-page Report is the term "customer" even mentioned.) More importantly, the rules submitted by Eurex U.S. fail to define and specify: 1) best execution requirements and other standards by which customer interests are protected; and 2) whether and how Eurex U.S.'s clearing members are required to specifically disclose the acceptance of such payments to their customers.[13]

The Application, premised upon the payment for order flow program, is thus inconsistent with the Act. Moreover, to the extent that Eurex U.S. desires to implement a payment for order flow program, the Commission should publish any such proposal in the *Federal Register* and provide for a public comment period in which interested parties are afforded the opportunity to submit their views on this controversial practice.[14]

C. Market Surveillance Concerns and Deficiencies.

1. Outsourcing to the NFA.

Eurex U.S. has stated that its compliance and surveillance functions will be performed under a regulatory services agreement with the NFA (an agreement that Eurex U.S. has asked the Commission to keep confidential). To our knowledge, however, NFA's Board of Directors (the "Board") has not been presented with nor considered the purported agreement. Importantly, the NFA's Articles of Incorporation specifically prohibit the provision of regulatory services to any

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[13] See, for example, the following SEC approval orders regarding rule changes filed under Section 19(b) of the Securities Exchange Act by various securities exchanges seeking to begin payment for order flow programs on their exchanges: Securities Exchange Act Release No. 43833 (January 10, 2001), 66 FR 7822 (January 25, 2001) (SEC order approving the payment for order flow program of the International Securities Exchange); Securities Exchange Act Release No. 47090 (December 23, 2002), 68 FR 141 (January 2, 2003) (SEC order approving the reinstatement of the Philadelphia Stock Exchange's payment for order flow program); and Securities Exchange Act Release No. 48053 (June 17, 2003), 68 FR 141 (June 25, 2003) (SEC order approving the reinstatement of the American Stock Exchange's payment for order flow program).

See also the following SEC rules pertaining to disclosure obligations and standards for broker-dealers: Rule 10b-10 under the Securities Exchange Act (requiring broker-dealers to disclose on confirmations whether they received payments for order flow, and that the source and nature of the compensation will be provided upon request); Rule 11Ac1-3 under the Securities Exchange Act (requiring broker-dealers to disclose for each new account and annually thereafter on an annual account statement, the broker-dealers' policies regarding receipt of payments for order flow, including a detailed description of the nature of the compensation received and information about their order routing policies, including whether orders can be executed at prices superior to the best bid and offer); and Rule 11Ac1-6 under the Securities Exchange Act (requiring broker-dealers to make publicly available a quarterly report regarding their routing of orders for execution. This report must include a description of any arrangements for payment for order flow).

[14] In 2000, the SEC published and provided a public comment period with respect to the International Stock Exchange's proposal to adopt a payment for order flow fee program. *See* Securities Exchange Act Release No. 43462 (Oct. 19, 2000).

market without Board approval. Because the Board has not approved the proposed arrangement, the Application is not ripe for Commission determination.[15]

In addition, the Application does not explain how the NFA will carry out the compliance functions or how it will assure that the costs associated with these functions are not being borne by other industry participants, like CME and other extant exchanges, which contribute significant funds to the NFA. Further, the Application makes no mention of whom or what will substitute for the NFA should it decline to provide the regulatory services. It is simply premature to publish an application for comment when an essential element of the public protection program is so uncertain.

Finally, we question the NFA's ability to provide adequately such regulatory services. The NFA has not demonstrated that it possesses the resources or skills necessary to effectively monitor futures exchanges. Indeed, with respect to a recent Commission Rule Enforcement Review of the BrokerTec Futures Exchange ("BTEX"), the Commission found that, "in reviewing BTEX's program for enforcing its block trading and exchange of futures for physicals ("EFP") rules, NFA did not examine an adequate number of block trades or EFPs to ensure compliance with BTEX rules."[16] In comparison to the ambitions of Eurex U.S., BTEX is a relatively small futures exchange. Prior to assuming responsibility over Eurex U.S.'s regulatory functions, the Commission should require the NFA to demonstrate that it has the capability to perform the services contemplated in the agreement between Eurex U.S. and the NFA.

An application for designation must demonstrate a capacity to prevent market manipulation or an effective delegation of that function. The delegation to NFA does not meet that test. While the Application is deficient in describing the business plan, Eurex U.S. has publicly declared that it intends to trade fungible versions of a number of Euro denominated contracts by means of the facilities of Eurex U.S. and of Eurex Frankfurt. It also plans to operate a clearing system that permits customers to lodge transactions completed on Eurex Frankfurt facilities in the U.S. clearing house. Thus, massive changes in open interest, manipulative wash trades, and any number of additional abusive trading practices that affect Eurex U.S. and other

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[15] Irrespective of any purported agreement between USFEX and the NFA, the Exchange does not believe that the NFA has the authority to provide such services. Specifically, in 2001, the NFA amended Section 1 of Article III of its Articles of Incorporation to permit the NFA to provide "such regulatory services to such markets as the Board may from time to time approve. . . ." In proposing the amendment, the NFA sought to provide services to evolving electronic exchanges and B2B exchanges that did not compete directly with existing exchanges. The NFA did not contemplate providing wholesale regulatory services to an exchange like USFEX, which not only operates an established platform, but competes directly with existing exchanges. Moreover, Section 1 of Article III expressly provides that the section is limited to Section 2 of Article III, which provides that the NFA "shall not adopt, administer or enforce any . . . rule, standard, requirement or procedure which purports to govern . . . (iv) the content, interpretation, administration or enforcement of any rule, standard, requirement or procedure of a contract market or clearing organization [or] (v) the conduct of business or other activities on the trading floor of a contract market." Section 2 thus imposes an absolute prohibition on the NFA from performing these regulatory functions for USFEX.

[16] *See* Press Release No. 4847-03, CFTC, Rule Enforcement Review of the BrokerTec Futures Exchange (Oct. 2, 2003).

U.S. futures markets can take place in an arena that is not subject to the regulatory reach of NFA. Moreover, NFA has not demonstrated that it has the capacity to regulate effectively and prevent market manipulation in the international context.

An application for designation must also demonstrate that the applicant has enacted and can enforce fair and equitable trading through the facilities of the contract market and the capacity to detect, investigate, and discipline any person that violates the rules. Eurex U.S. does not demonstrate that capacity by delegating its regulatory function to NFA, which is unproved in this arena, and to other entities that are not regulated by the CFTC.

2. Deficient Trade Practice and Market Surveillance Rules.

A fundamental precept under the Act is that exchanges enact and enforce comprehensive trade practice and market surveillance rules to ensure fair and equitable trading.[17] As indicated in Attachment B, the Rules of Eurex U.S. do not meet the high standards required by the Act.

D. Clearing and Risk Management Deficiencies.

A clearing and settlement system requires logical, comprehensive and detailed procedures. As discussed more fully below, Eurex U.S.'s Rules fail to spell out how many of the procedures would be performed, in contravention of Designation Criterion 5 of the Act.[18]

1. The Proposed Clearing Arrangement.

It appears from public statements made by Eurex U.S. and The Clearing Corporation (the "CC") that CC has agreed to provide clearing and settlement services. The alleged agreement has been submitted to the CFTC but has not been made available to the public, despite repeated requests by CME. CFTC's refusal to provide the requested agreement is particularly objectionable given the fact that CME and CBOT immediately granted permission to the Commission to release our Clearing Services Agreement upon receiving a request from the Futures Industry Association. Accordingly, the Application is premature for consideration by the Commission.

Moreover, we note that a significant aspect of the proposed clearing arrangement does not appear to satisfy Designation Criterion 5 of the Act and Core Principle 11 of the Act,[19] each

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[17] *See, e.g.*, Designation Criterion 3 of the Act provides, which provides, in part, that: "The board of trade shall establish and enforce trading rules to ensure fair and equitable trading through the facilities of the contract market, and the capacity to detect, investigate, and discipline any person that violates the rules."

[18] Designation Criterion 5 of the Act provides, in part, that: "The board of trade shall establish and enforce rules and procedures for ensuring the financial integrity of transactions entered into by or through the facilities of the contract market, including the clearance and settlement of the transactions with a derivatives clearing organization."

of which require that transactions executed on a designated contract market be cleared and settled through a registered derivatives clearing organization ("DCO"). According to the representations of Eurex Frankfurt, Eurex Frankfurt and Eurex U.S. intend to develop a "transatlantic marketplace" through a "global clearing solution" involving both Eurex Clearing AG ("Eurex Clearing") and the CC.[20] With respect to the fungible Euro-denominated products that Eurex U.S. intends to offer, the arrangement would appear to allow members of Eurex U.S. or Eurex Clearing to choose to clear their respective Eurex U.S. or Eurex Frankfurt trades either through the CC or Eurex Frankfurt. However, because the proposed arrangement contemplates that trades executed on Eurex U.S. may be cleared at Eurex Clearing by a Eurex Frankfurt clearing member, the Act requires Eurex Clearing to obtain designation as a DCO. To our knowledge, Eurex Clearing has not obtained such a designation. As a result, a fundamental aspect of Eurex U.S.'s clearing proposal does not conform to the Act.

CME and other industry participants are severely constrained in commenting on an arrangement that could materially impact the financial safety and soundness of the U.S. futures markets. Accordingly, CME reiterates its request that the proposed clearing arrangement be made public and that commentators be given an opportunity to provide comments.

2. Deficient Financial Integrity and Customer Protection Rules.

As indicated in Attachment C, various Eurex U.S. rules do not adequately ensure the financial integrity of transactions entered through the proposed Trading System.

E. Recordkeeping Rule Deficiencies.

In an effort to prevent customer and market abuses, the Act requires exchanges to establish and enforce strict recordkeeping requirements.[21] As indicated in Attachment D, however, the Application is rife with recordkeeping deficiencies.

F. Operational Concerns.

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[19] Core Principle 11 of the Act provides that: "The board of trade shall establish and enforce rules providing for the financial integrity of any contracts traded on the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization). . . ."

[20] *See e.g.*, *Id.*; Press Conference, Eurex Frankfurt, *New Opportunities for Derivatives Trading and Clearing* (September 16, 2003); Press Release, Eurex Frankfurt, *Partnership Deal signed between The Clearing Corporation and Eurex* (September 4, 2003).

[21] *See* Core Principle 10 of the Act provides that: "The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market."

According to the Application and press reports, Eurex U.S. is seeking to outsource a significant portion of its operation of the proposed exchange to foreign-based entities (*i.e.*, Eurex Frankfurt and Deutsche Borse AG). Specifically, Eurex U.S. has allegedly entered into two outsourcing agreements: 1) a General Services Agreement with Eurex Frankfurt; and 2) a Service Level Agreement between Deutsche Borse AG and Eurex Frankfurt. Neither of these documents has been made public. Given the significance of the alleged outsourcing, it is untenable that these documents have not been made public. Accordingly, CME reiterates its request that the proposed outsourcing agreements be made public and commentators be given an opportunity to provide comments.

Moreover, Section 5c(b) of the Act provides that an exchange "may comply with any applicable core principle through delegation of any relevant function." However, the section further requires that the delegation occur to a "registered futures association or another registered entity." Deutsche Borse AG and Eurex Frankfurt do not satisfy this requirement, thus making the Application fatally flawed.

G. Product-related Concerns.

The Application does not demonstrate compliance with Core Principle 7 of the Act because the specifications of the contracts that Eurex U.S. intends to offer for trading have not been made part of the Application. Core Principle 7 requires a board of trade to make information available to the public, concerning among other things, the terms and conditions of its contracts. The Application fails to include any specifications of the contracts that Eurex U.S. intends to offer for trading. Eurex U.S. has, in fact, made this information known to selected customers and shareholders of The Clearing Corporation; outrageously however, it has failed to provide this very same information to the CFTC and the public record.[22]

Conclusion

Eurex U.S.'s Application is not only unacceptably vague, but fatally flawed under the Act. The Application seeks to affect a radical shift in Commission policy, in which a designated contract market is effectively permitted to operate as a "black box" where all critical regulatory, operational and clearing functions are outsourced to third-parties, some of whom are not accountable to the Commission. We urge the Commission to disapprove the proposal as filed. In addition, the filing is so deficient in material respects that it cannot possibly be considered by the Commission in its present form. At a minimum, Eurex U.S. should be required to supplement or amend the filing to fill in the gaping holes and commentators should be given another opportunity to submit comments.

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[22] See report entitled "Global Access to the World's Benchmark Derivatives" dated September, 2003. (Full report not attached.) and Footnote 20 *infra*. See also Proxy Statement of The Clearing Corporation dated September 24, 2003.

If you have any questions or comments, please do not hesitate to contact me, Matthew F. Kluchenek, Director and Associate General Counsel, at (312) 338-2861, or Jerry Salzman, at (312) 222-5131.

Respectfully submitted,

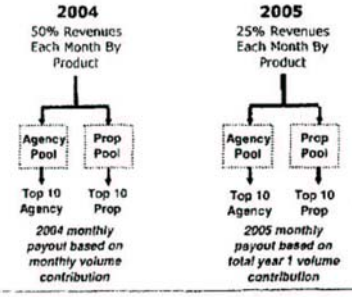
Craig S. Donohue
Office of the CEO

ATTACHMENT A

eurex

Aligning Your Interest With Our Success

- ✓ A revenue rebate plan for the US Treasury derivative products will run for the first two years of Eurex US operations
  - 50% of trading fee revenues on the first year of operation
  - 25% of trading fee revenues on second year of operation
- ✓ Revenue will be refunded on a monthly basis to Top 10 firms in agency and Top 10 in prop/market making activity, in proportion to their volume
- ✓ Total contribution in year 1 will determine share in year 2



Potential Pay-out

Eurex Mkt Share (end '05)	Total Projected Rebate* ($ MM)
25%	8-11MM
50%	15-20MM
75%	25-30MM
100%	30-40MM

Projected equivalent of up to $0.05-0.10 rebate**

*10% annual market growth assumed **Average top 10 participant in year 1

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ATTACHMENT B

DEFICIENT TRADE PRACTICE AND MARKET SURVEILLANCE RULES.

The Rules of Eurex U.S. do not meet the high standards required by the Act. For example,

(a) Eurex U.S. Rule 401—Business Day Periods.

Rule 401 is ambiguous because it repeatedly uses the terms "orders" and "quotes," but nowhere are the terms defined in the Rules. Thus, with respect to Rule 401(b)(iii), which states that, "[i]f no market orders exist that can be matched with quotes or limit orders for any futures delivery months or series of futures options and matching between limit orders or limit orders and quotes is not possible, the Opening Period shall end without the determination of an opening price[.]" The application of the rule is patently unclear.[23]

(b) Eurex U.S. Rule 403(e)—Average Price Trades.

Rule 403(e) fails to prescribe the audit trail requirements for APS confirmations. Moreover, the rule does not require customer consent or prohibit the bunching of customer and proprietary trades in the calculation group, as the Commission has previously required.

(c) Eurex U.S. Rule 405—Confirmations and Objections.

Rule 405 states that Eurex U.S. is required to "immediately notify a Member of the matching of bids and offers through the Trading System." The rule further provides that objections to the contents of the confirmations must be submitted to Eurex U.S. by no later than the beginning of the trading for the relevant Contract on the next Business Day.

Rule 405 thus awkwardly permits a Customer to receive a fill confirmation immediately following the trade execution, only to learn the following Business Day that the trade was cancelled because the counterparty's Clearing Member has objected to the trade. Perhaps even more alarming, however, the rule does not set forth the specific (or even general) circumstances under which an order may be challenged. It also does not require the Member to communicate to the Customer the grounds upon which the order was challenged.

(d) Eurex U.S. Rule 406—Cross Trades and Pre-arranged Trades.

Rule 406 is perhaps the most troubling and potentially harmful aspect of Eurex U.S.'s proposed trading system. The rule is artfully cloaked as a proscription, but creates a gaping hole to permit the internalization of futures orders and preferential treatment to Members. Specifically, Rule 406 provides that:

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[23] *See also* Rule 403, in which "orders" appears to refer both to "orders" and "quotes" and are confusingly interpolated into such terms as "Order Book," "Combination Order," "Combination Quotes," "Combination Order," "Combination Quote Book," and "Options Combination Quote Book."

> . . . no Member shall enter into a pre-negotiated transaction or knowingly assume on its own behalf or on behalf of another Customer the opposite side of a Customer order except where:
>
> > (a) In the case of a Customer order, the Customer has given consent thereto (which may be in the form of a blanket consent); and
> >
> > (b) The Member seeking to match Customer orders, to take the opposite side of a Customer or to execute a pre-negotiated transaction, waits 5 seconds in the case of Futures Contracts or 15 seconds in the case of Option Contracts after the initial order is entered into the Trading System before entering the opposite order.

Eurex U.S. arguably crafted Rule 406 to facilitate the internalization of futures orders without price discovery and the exposure of orders to the marketplace. Again, we agree with former SEC Chairmen Arthur Levitt and Harvey Pitt that internalization should be proscribed because orders are neither exposed nor transparent to the marketplace, thus depriving customers of competitive executions.[24]

As proposed, the rule would permit a Member to pre-negotiate a transaction with a Customer at a price that is unfair to the Customer, to then enter that unfair price into the Trading System and wait for five seconds and then execute the Customer order opposite the unfair price. In order to comply with basic standards of fairness, the Customer's side of the order should always be exposed to the market in order to secure a beneficial execution for the Customer.

Rule 406 is also flawed because it does not prohibit Members from withholding Customer orders. Because Members do not have to immediately enter Customer orders into the Trading System, a Member can wait for the ideal opportunity (perhaps a blip or a gap in the bid/ask spread) to cross the Customer order at a price that benefits the Member. This problem is exacerbated by the provision of blanket Customer agreements to cross trades. The Customer

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[24] The potentially harmful consequences of internalization have also raised significant concerns with the SEC. For example, in 1999, former SEC Chairman Arthur Levitt stated that: "I worry that best execution may be compromised by payment for order flow, internalization, and certain or the practices that can present conflicts between the interests of brokers and their customers." SEC Chairman Arthur Levitt, *Best Execution: Promise of Integrity, Guardian of Competition*, Remarks at Securities Industry Association Conference (Nov. 4, 1999).

Moreover, in early 2003, former SEC Chairman Harvey Pitt urged the five U.S. options exchanges to voluntarily abolish exchange-sponsored internalization (and payment for order flow) programs. In the letter to the exchanges, Chairman Pitt stated that: "I am seriously concerned that economic inducements to order-flow providers and internalization by member firms create serious conflicts of interest that can compromise a broker's fiduciary obligation to achieve best execution of its customer orders." *See, e.g.,* Letter from Harvey Pitt, Chairman, SEC, to Meyer Frucher, Chairman, Phlx (Jan. 24, 2003).

More recently, in a written response to the U.S. Senate, Chairman William Donaldson has stated that: "Like payment for order flow, internalization can discourage markets from competing on the basis of price and pose a conflict of interest for broker-dealers."

may not be able to discern when his orders are being exposed to the market and when they are being held for convenient execution at a disadvantageous price.

Finally, the rule appears to pertain only to cross and pre-arranged trades involving Customer orders. As proposed, Member-to-Member pre-arranged transactions appear not to be prohibited.

Rule 406 thus violates Designation Criterion 3 of the Act, Core Principle 9 of the Act[25] and Core Principle 12 of the Act.[26]

(e) Eurex U.S. Rule 408—Cancellation of Transactions.

Eurex U.S.'s proposed trade cancellation rule, Rule 408, is beset by numerous defects. For example, the rule:

- fails to mention that market volatility or major events may impact the decision making process;
- provides an overly broad 15 minute threshold during which trades can be challenged—a problem with respect to, among other things, cross exchange arbitrage, where other exchanges generally limit timeframes to under 10 minutes;
- fails to contemplate spreads, both inter and intra-commodity, in the product range table;
- fails, with respect to the published ranges for options, to incorporate implied volatility or deltas;
- fails to clarify whether contingency orders elected outside the "applicable range" can be matched inside the "bust" range; and
- allows traders to execute counter transactions in order to unwind errors, which would create false volume.

(f) Eurex U.S. Rule 413—Exemptions from Position Limits.

Rule 413 does not incorporate or reference CFTC Regulation 1.3(z)(1) or otherwise restrict exemptions to hedge positions. The blanket granting of exemptions would render position limits useless for the prevention of market manipulation, in contravention of Designation Criterion 2 of the Act[27] and Core Principle 5 of the Act.[28]

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[25] Core Principle 9 of the Act provides, in part, that: "The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions."

[26] Core Principle 12 of the Act provides that: "The board of trade shall establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants."

[27] Designation Criterion 2 of the Act provides, in part, that: "The board of trade shall have the capacity to prevent market manipulation through market surveillance, compliance, and enforcement practices and procedures. . . ."

[28] Core Principle 5 of the Act provides that: "To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculator, where necessary or appropriate."

(g) Eurex U.S. Rule 414—Position Accountability.

Rule 414 permits Eurex U.S. to establish Position Accountability levels for any contract, but ignores the Commission's standards for determining the types of accountability permissible for a particular contract, which depends upon the liquidity of the contract and the underlying market. The Commission's standards are not incorporated into the rule in any meaningful respect, in violation of Designation Criterion 2 of the Act and Core Principle 5 of the Act.

(h) Eurex U.S. Rule 415—Block Trading.

Rule 415 lacks the "fair and reasonable" pricing requirement for block transactions set forth in Core Principle 9, which provides that: "A designated contract market that determines to allow block transactions should ensure that the block trading does not operate in a manner that compromises the integrity of prices or price discovery on the relevant market." Moreover, the rule does not appear to require the dissemination of the details of block trades. Rather, 415(j) simply states that Eurex U.S. "shall promptly notify the Members of the details of the Block Trade upon confirmation." It is unclear whether the term Members refers to all Members of the exchange, or only the Members involved in the trade. To the extent that all Members learn of the trade, the rule does not describe whether, or how, the reporting of block trades will be differentiated from other types of trades.

(i) Important Matters Not Addressed in the Rules.

Not only are many of Eurex U.S.'s rules defective under the Act, but the Rules fail to address several trade practice-related matters that are vital to the integrity of the futures markets. For example:

- The Rules do not specifically require the entry of Customer orders in the order of receipt, in violation of Designation Criterion 3 of the Act and Core Principle 12 of the Act;
- The Rules do not specifically prohibit the disclosure of orders prior to execution, in violation of Designation Criterion 3 of the Act and Core Principle 12 of the Act;
- The Rules do not specifically prohibit the withholding of orders from the market, in violation of Designation Criterion 3 of the Act and Core Principle 12 of the Act; and
- The Rules do not adequately establish fitness standards for *all* persons that may have direct access to the Trading Facility, in violation of Core Principle 14 of the Act.[29]

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[29] Core Principle 14 provides that: "The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other persons with direct access to the facility (including any parties affiliated with any of the persons described in this paragraph.)"

ATTACHMENT C

DEFICIENT FINANCIAL INTEGRITY AND CUSTOMER PROTECTION RULES.

Various Eurex U.S. rules do not adequately ensure the financial integrity of transactions entered through the proposed Trading System. For example,

(a) Eurex U.S. Rules 302 and 307—Minimum Financial Standards.

Rather than provide specificity, the Rules vaguely sketch the minimum financial requirements for Members. For example, Rule 302(iv) states that "the applicant shall have adequate financial resources and credit." Rule 307(l) mentions that Members are required to maintain their financial resources at or in excess of the amount prescribed by Eurex U.S. Notably, however, the rules do not refer to or incorporate the specific requirements of CFTC Rule 1.17, which sets forth detailed minimum financial standards. At the same time, the Rules do not appear to specify any requirements for non-registered clearing firms.

(b) Eurex U.S. Rule 307— Protection of Customer Funds.

While Rule 307(b)(x) requires Members and Clearing Members to notify Eurex U.S. if they fail to maintain segregated funds as required by the Commission, the Rules do not provide any guidance as to the types of funds that may or may not be segregated. Moreover, the Rules do not refer to or incorporate the specific CFTC rules that apply to the protection of customer funds. CFTC Rules 1.20 through 1.30 and 1.32 provide specific requirements for the protection of customer funds, namely the timely and accurate calculation of funds in segregation, maintenance of sufficient funds in segregation and the appropriate establishment of customer regulated accounts. The Eurex U.S. Rules do not provide its Members with any guidance in this area.

(c) Eurex U.S. Rule 506—Margins.

Rule 506 purports to set forth the Members' obligations with respect to margin, but the rule is silent with respect to acceptable collateral and margin policies. The Rules only address the amount of margin to be collected by Members from its customers. In addition, while the Rules provide that the Members "must collect from its customers additional margin in an amount and at such time as [Eurex U.S.] may from time to time determine," they do not provide any guidance on the factors that may be considered by Eurex U.S. in requiring additional margin. In addition, there is no guidance on when margin calls will or should be made, what types of collateral can be deposited by customers to satisfy margin calls, under what conditions new orders may be accepted, when funds may be disbursed, when positions must be liquidated and the consequences of not maintaining sufficient margin. Such important guidance appears absent from Eurex U.S.'s Application.

(d) Member Defaults.

Except for a brief reference to Member defaults in Eurex U.S.'s membership application, the Rules fail to set forth the appropriate treatment of Customer collateral and the actions, if any, that a defaulting Member must take to transfer positions to a non-defaulting Member.

ATTACHMENT D

RECORDKEEPING RULE DEFICIENCIES

Eurex U.S.'s Application is rife with recordkeeping rule deficiencies. For example,

1. Eurex U.S. Rule 307(d)—Commission Recordkeeping Requirements.

Core Principle 10 of the Act imposes requirements upon DCMs with respect to the "recording and safe storage of all identifying trade information." However, in vaguely mentioning that Members must maintain records "showing the details and terms of all transactions in all Contracts," Rule 307(d) fails to specify the types of records that Members are required to maintain. The failure to specify such records is likely to hamper Eurex U.S.'s ability to use such information to prevent and detect customer and market abuses.

2. Eurex U.S. Rule 307(j)—Contracts Entered Under ID.

Rule 307(j) and its companion rules set forth unsatisfactory minimal audit trail requirements. Most importantly, the Rules do not appear to require terminal operators to enter an ID or an account number into the Trading System prior to entering an order.[30] Without such basic information, Eurex U.S. cannot adequately conduct audit trail analyses to decipher improper conduct.

3. Eurex U.S. Rule 307(n)—Priority of Customer Order Entry.

Rule 307(n) attempts to prescribe the priority of Customer orders, but contains a major gap. The rule appears to allow a Member that receives a Customer order to ask or instruct a terminal operator to enter a third-party order into the Trading System, provided that neither the terminal operator nor the third-party are aware of the Customer order. The rule thus permits the potential withholding and front-running of Customer orders.

[30] To the extent that such information is buried in USFEX's systems manuals, we believe that such important information should be part of the Rules promulgated by USFEX.