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October 9, 2007

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

Re: CME Petition for Exemption from Registration as an FCM on behalf of CFETS, 72 *Fed.Reg.* 48262 (August 23, 2007)

Dear Mr. Stawick:

The Futures Industry Association ("FIA")[1] appreciates the opportunity to comment on the petition that the Chicago Mercantile Exchange ("CME") has filed on behalf of the China Foreign Exchange Trading System ("CFETS") and its members for an exemption from registration as a futures commission merchant ("FCM"). The petition was filed pursuant to section 4(c) of the Commodity Exchange Act ("Act"), which authorizes the Commodity Futures Trading Commission ("Commission") to exempt any person from any provision of the Act if, among other things, the Commission finds that the exemption "would be consistent with the public interest." For the reasons set forth in detail below and based upon the record available to us, we submit that the CME has not made the showing required under the provisions of section 4(c) of the Act to support its request for exemption.[2]

The CME petition on behalf of CFETS

As described in the *Federal Register* release, CFETS is a not for profit affiliate of the People's Bank of China ("PBC"), which "operates an electronic trading system with respect to trading in the interbank foreign exchange market, Renminbi (RMB) lending, and trading on the bond

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[1] FIA is a principal spokesman in the United States for the commodity futures and options industry. Our regular membership is comprised of approximately 40 of the largest FCMs in the United States, all but six of which are clearing members of the CME. FIA estimates that our members are responsible for more than 90 percent of all customer transactions executed on US contract markets.

[2] Our comments are based on the limited information set out in the *Federal Register* release and certain additional information provided orally by CME staff in a meeting with representatives of several FIA member firms on Thursday, September 27. At the meeting, CME staff advised these firms that the terms and conditions of the agreement between the CME and CFETS referenced in the *Federal Register* release would not be made available to them for review. Without access to this agreement, our ability to comment fully is limited.

market in China. . . . CFETS also operates China's Interbank RMB money market and facilitates the trading of government securities and repo transactions."[3]

The CME has entered into an agreement with CFETS, pursuant to which CFETS will become a "super clearing" member of the CME, authorized to clear foreign currency and interest rate futures contracts on behalf of CFETS members, which include all of the major Chinese banks and their customers located in China. As noted in the *Federal Register* release, the Commission historically has taken the position that a foreign broker that clears transactions on behalf of customers directly through a US-based clearing organization must be registered with the Commission as an FCM.[4] However, the CME has advised the Commission that CFETS is not separately capitalized and, therefore, would not be able to comply with the Commission's minimum net capital rules. 17 CFR §1.17. For the same reason, CFETS would not be able to file an annual report certified by an independent public accountant in accordance with Commission rule 1.16, as required by Commission rule 1.10(b)(1)(ii). Consequently, CFETS is unable to satisfy the requirements for registration as an FCM and, unless the CME's petition for exemption is granted, will be unable to become a "super-clearing" member of the CME.

The CME has not met its burden under section 4(c) of the Act.[5]

At the outset, we want to emphasize that we are encouraged by the Chinese government's recent actions to expand the ability of Chinese banks and other financial institutions to use the futures markets to hedge their foreign currency and interest rate risks, and we are excited about the opportunities that such expansion presents to FIA member firms. We are also pleased that the PBC has called upon the expertise of the CME to provide consulting and technical assistance to CFETS. Nonetheless, the CME has provided no compelling reason why the Commission should deviate from its consistent, historic policy and permit CFETS to become a clearing member of the CME for the purpose of clearing transactions on behalf of its member institutions located in China and their customers without being registered as an FCM.

The CME has asserted that CFETS requires an exemption from registration as an FCM because, as a not-for-profit affiliate of the PBC, CFETS is not separately capitalized. However, the CME has not suggested any reason why CFETS cannot be separately capitalized. Is there some reason why, as a matter of law, CFETS cannot be separately capitalized or why CFETS could not form an affiliate that would be separately capitalized? Nor has the CME explained why it is necessary

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[3] 72 *Fed.Reg.* 48262-48263 (August 23, 2007). The capacity in which CFETS conducts its activities is unclear. As described by the CME, CFETS would appear to be acting primarily in the capacity of a foreign board of trade rather than a foreign broker. If that is the case, the Commission should consider whether the relationship that the CME and CFETS have entered into under the terms of the agreement is more in the nature of a joint venture between boards of trade and should be analyzed accordingly.

[4] As the Commission further notes, it reaffirmed this position no less than six months ago. 72 *Fed.Reg.* 15637 (April 2, 2007).

[5] Our comments are focused on the request that CFETS be exempt from registration as an FCM. We note, however, that the CME petition would extend the requested relief to CFETS members as well. Based on the information set forth in the *Federal Register* release, we can discern no reason why CFETS members would be engaging in activities that would require registration as FCMs and, therefore, will not address this aspect of the CME petition. Nonetheless, if any CFETS member were to engage in activities that, under the Act and existing Commission interpretations, would require registration as an FCM, that member should be so registered.

for CFETS to become a CME clearing member at all. Is there some reason why, as a matter of law, CFETS and its members cannot open accounts with other authorized brokers and, through them, with CME clearing members that are registered as FCMs?

To grant a petition for exemption, the Commission must find that the exemption: (1) will promote economic or financial innovation and fair competition; (2) will be consistent with the public interest and the purposes of the Act; and (3) will not have a material adverse affect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act. The CME has chosen not to address any of these statutory standards and, therefore, it has not met its burden under section 4(c).

The exemption would not promote economic or financial innovation and fair competition.

Based on the information available to FIA, there appears to be no factual evidence that would support the several Commission findings that section 4(c) requires. For example, although the CME and CFETS no doubt anticipate economic or financial *benefits* from the venture that they have entered into, the *Federal Register* release discloses no financial or economic *innovations* that are expected to flow from the relationship, in particular, innovations that would require CFETS to become a clearing member of the CME. Nor would the requested relief promote competition. Rather, allowing CFETS to become a clearing member without first being registered as an FCM would likely result in CFETS having a competitive advantage in soliciting Chinese banks and other institutional clients to trade on the CME and CBOT.

When an FIA member firm, or an affiliate, makes the decision to enter a new market, it must comply with the applicable laws and regulations of the country in which the market is located, in addition to the rules of the market itself, including all financial, recordkeeping and reporting, and customer protection requirements.[6] The firm would also be subject to disciplinary proceedings for violating any such laws or regulations. If CFETS wants to enjoy the benefits of being a clearing member of the CME, we see no reason why it, or an affiliate formed for this purpose with dedicated capital, should not likewise subject itself to the laws and regulations of the United States, in particular the Act and Commission regulations, as well as the risk of disciplinary actions thereunder.

The Chinese market has just begun to open to non-Chinese brokers, and FIA member firms look forward to competing among each other and with their Chinese counterparts for the opportunity to serve the many banks and other institutions that may trade on US contract markets, including the banks and institutions that are CFETS members. "Fair competition", however, requires that all CME clearing members be subject to the same US laws and regulations and contract market and clearing organization rules.

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[6] In China, for example, foreign brokerage firms initially will not be permitted to establish independent entities. Instead, foreign firms currently are permitted to participate in Chinese markets only through taking minority interests in local brokerage firms.

The exemption would not be consistent with the public interest and the purposes of the Act.

The underlying purposes of the Act and, consequently, the public interests to be served—customer protection, market integrity and financial integrity—are achieved in substantial part through compliance with the provisions of section 4f and 4d of the Act, which require (1) the registration of all persons acting in the capacity of an FCM and (2) the segregation of all funds received by an FCM to margin, guarantee or secure transactions executed on designated contract markets. Section 4d imposes a similar obligation on clearing organizations and specifically prohibits a clearing organization from treating any customer funds received from an FCM as belonging to such FCM.

For their part, designated contract markets and derivatives clearing organizations ("DCOs") foster the purposes of the Act and the public interest by compliance with the core principles set out in sections 5 and 5b, respectively. Of particular relevance for our analysis are the following core principles for derivatives clearing organizations: (1) F, which provides that a DCO must have standards and procedures designed to protect and ensure the safety of member and participant funds; (2) G, which requires a DCO to have rules and procedures designed to ensure the efficient, fair and safe management of events when members and participants become insolvent or otherwise default on their obligations to the DCO; (3) M, which requires a DCO to enter into and abide by all appropriate and applicable domestic and international information sharing agreements; and (4) N, which requires a DCO to avoid adopting any rule or taking any action that results in any unreasonable restraint of trade, unless necessary to achieve the purposes of the Act.

The requested exemption would appear to be inconsistent with each of these provisions of the Act and would result in a loss of the protections they are designed to assure. Yet, the CME's petition provides no information to explain why, notwithstanding such inconsistencies, the exemption would be consistent with the public interest.

Registration has been called a linchpin of the Commission's regulatory program, and properly so. Registration identifies to the Commission, the public and other governmental agencies the individuals and entities that are properly authorized to solicit and accept customer orders. More important, registration assures that registrants, wherever located, are subject to the provisions of the Act and the Commission's rules and, in connection therewith, are subject to the jurisdiction of the Commission, the Department of Justice and the US courts.

Registration as an FCM is imperative in the case of a member of a clearing organization that clears customer transactions. Given the critical role that clearing members play in assuring (1) the efficient operation of the exchange markets, (2) compliance with applicable Commission and exchange trade practice requirements and, in particular, (3) the financial integrity of exchange transactions, it is essential that the Commission's jurisdiction and authority over clearing members be unimpaired.

If the Commission were to grant the CME petition and exempt CFETS from the requirement that it be registered as an FCM, the regulatory benefits arising from such registration would be lost, or at least significantly impaired. Critically, only an FCM has an obligation to segregate customer funds and to hold and treat such funds as separate from its own; only an FCM is a

commodity broker under Subchapter IV of Chapter 7 of the Bankruptcy Code and Part 190 of the Commission's rules (with respect to transactions executed on a designated contract market). If CFETS were not required to be registered as an FCM, therefore, the legal uncertainty with respect to their status would deny CFETS customers the protections generally accorded customer funds under the Act.

This is especially true in the event, however unlikely, that CFETS were to default on its obligations to the CME. How would such an event be treated under the Bankruptcy Code? Would the Commission have any right to be heard as provided in section 762 of the Code? Would Part 190 of the Commission's rules be applicable? Would CFETS customers have a priority with to respect to CFETS assets held at the CME? Would CFETS customers have a priority with respect to other CFETS assets? Would CFETS customers have the right to expect that they would receive such priority? Would positions of CFETS customers be able to be transferred to non-defaulting FCMs? Without knowing the answers to such questions, the CME would be unable to demonstrate compliance with core principles F and G.[7]

As noted earlier, if the Commission were to grant the CME petition and exempt CFETS from the requirement that it be registered as an FCM, CFETS would not be subject to the jurisdiction of the Commission, the Department of Justice or the US courts. Although we understand that CFETS may have waived to some extent the sovereign immunity to which it may be entitled as an affiliate of the PBC, we are not aware of the extent to which CFETS may have done so. In any event, we suggest that any such waiver (even if effective) would be of limited value, since CFETS apparently has no assets. We submit, therefore, that the Commission should consider carefully the scope of any such waiver and the impact that the sovereign immunity of CFETS may have on the Commission's regulatory program and the right of other clearing members to seek redress under section 22 of the Act.[8]

We recognize that the Commission has granted exemptions from registration as an FCM, but only in limited circumstances. Under Commission rule 3.10(c), for example, entities that trade solely for proprietary accounts are exempt from registration. In addition, in accordance with Commission rule 30.10, the Commission has granted exemptions to foreign firms that have met the criteria set forth in Appendix A to Part 30. That is: (1) the activities of such firms are limited to soliciting or accepting orders for execution on foreign boards of trade; (2) the Commission has found that such firms are subject to comparable regulation in the jurisdiction in which they are located, including matters such as registration qualifications, minimum capital requirements, recordkeeping and reporting requirements, sales practice standards, and compliance; and (3) the Commission and the appropriate governmental authority or self-regulatory organization have entered into an information sharing arrangement, assuring the Commission access to information

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[7] The CME has advised FIA member firms that the Commission staff insisted that, if the exemption were granted, CFETS funds would have to be held in the house account rather than the customer funds account maintained by the CME in its capacity as a DCO for the very reason that CFETS would not be registered. We do not disagree with the staff's conclusion and simply note that this only reinforces the concerns discussed above.

[8] In this connection, we note with some concern that CFETS did not join in the petition, make any representations or warranties concerning its structure and business activities, or directly agree to any undertaking suggested in the petition as a condition to the requested exemption being granted.

necessary to fulfill its regulatory responsibilities.[9] The Commission has not been asked to make, and has not made, a finding of comparability with respect to the Chinese regulatory system.

In any event, in the one case of which FIA is aware, the Commission staff declined to allow a foreign firm that qualified for an exemption from registration as an FCM pursuant to Commission rule 30.10 to become a member of a DCO without registration as an FCM. Enskilda Futures Limited ("Enskilda"), located in London, is an approved firm with the Financial Services Authority. Although Enskilda intended to clear only proprietary accounts and accounts of non-US customers, we understand that Commission staff advised Enskilda that it would have to be registered as an FCM. We see no reason to take a different approach here.[10]

Although the CME has crafted and has undertaken to enforce a form of "substituted compliance" to address some of the supervisory issues that would arise if its petition were granted, such "substituted compliance" is not an adequate substitute for the Commission's direct regulatory authority over CFETS.[11] Moreover, we are concerned that a critical aspect of the CME's "substituted compliance" program is its apparent agreement to be jointly and severally liable with CFETS "in any Commission enforcement action relating to compliance with any order issued by the Commission." The scope of any such liability would, of course, be defined by the scope of the Commission's order if it were to grant the CME's petition. Whatever its potential scope, under no circumstances should the CME assume joint and several liability for the violation of a Commission order by a member firm. As shareholders and clearing members of the exchange, FIA member firms assume a certain amount of financial risk. However, they have not assumed the risk that the value of their shares will be impaired as the result of a CME guarantee of the conduct of another member. The CME properly would not agree to be jointly and severally liable in any Commission enforcement action involving all of its members; it should not assume such responsibility with respect to one such member.

The proposed exemption would adversely affect the ability of the Commission and the CME to discharge their responsibilities.

Section 4(c)(2) of the Act provides, in part, that the Commission shall not grant an exemption under this section, unless the Commission determines that the exemption "will not have a material adverse effect on the ability of the Commission or any contract market . . . to discharge its regulatory or self-regulatory duties under this Act." For the reasons discussed above, we submit that the requested exemption would have such a material effect on the Commission's ability to discharge its regulatory responsibilities. Moreover, in light of the CME's agreement to

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9 FIA supported the adoption of Commission rule 30.10 and the exemptions from registration granted thereby. Although the exemptions were not granted pursuant to section 4(c), we note that the exemptions promoted economic innovation and fair competition among both markets and intermediaries.

10 If the petition were granted, we submit the Commission would have no basis to deny similar relief to other foreign brokers that might seek to become members of a derivatives clearing organization. Therefore, the Commission should consider carefully the regulatory implications of granting the petition.

11 For example, CME apparently has undertaken that it and CFETS will comply with US anti-money laundering requirements as determined by the US Treasury. The effect of this representation is unclear since neither the CME, as a DCM, nor CFETS, as an unregistered entity, is subject to US anti-money laundering requirements. In any event, the Commission should not waive its authority to enforce relevant anti-money laundering requirements.

be jointly and severally liable for CFETS conduct (to some undetermined extent), the CME would be placed in the untenable position of investigating itself. In particular, among other things, the CME's Compliance Department will be in the position of monitoring for trade practice abuses, granting hedge exemption requests, granting relief from other exchange requirements, determining which accounts should be aggregated for position limit purposes and setting position limits for these new market entrants. This inherent conflict of interest would impair the CME's ability to fulfill its self-regulatory responsibilities.

Conclusion

For all of the above reasons, FIA respectfully submits that the CME has not met its burden under section 4(c) of the Act. If, notwithstanding the foregoing, the Commission determines that the petition should be granted, subject to certain terms and conditions, we request that any such terms and conditions, as well as the contractual terms agreed by the parties, be published for additional comment before the Commission takes any action to approve the CME petition. We would be pleased to meet with the members of the Commission or staff at their convenience to discuss in greater detail the matters set forth in this letter.

Sincerely,

John M. Damgard
President

cc: Honorable Walter Lukken, Acting Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner

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