U.S. Futures Exchange, L.L.C.

311 S. Wacker Drive, Suite 3750
Chicago, IL 60606
Phone: (312) 408-4523
Fax: (312) 408-4529

November 18, 2003

Ms. Jean A. Webb, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

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

Dear Ms. Webb:

U.S. Futures Exchange, L.L.C. ("Exchange" or "USFE") appreciates the opportunity to respond to the public comments submitted in connection with the Exchange's application to the Commodity Futures Trading Commission ("Commission") for designation as a contract market pursuant to Sections 5(b) and 6 of the Commodity Exchange Act ("Act") and Part 38 of the Commission's Rules. The Exchange welcomes the open process that the Commission has employed in connection with its review of the Exchange's application. The public comment process permits the Exchange to recognize and address some of the misunderstandings that have arisen regarding the Exchange's application and its intended method of operation.

The Exchange is pleased by the strong public support it has received for its efforts to enter the U.S. market, particularly from the users of these markets. As the comments of the Futures Industry Association and Interactive Brokers Group, L.L.C. recognize, the establishment of USFE has the potential not only to lower trading costs for U.S. market participants, but also – through competition – to be an engine for overall growth in the U.S. futures market, to the benefit of all market providers, users, and ultimately the U.S. consumer.

Two commenters, however, raised a number of issues regarding our application for contract market designation, many based upon a misapprehension of the Exchange's application materials. This letter seeks to address those issues.

I. BACKGROUND

The Commodity Futures Modernization Act of 2000 ("CFMA"), a landmark reform of the Commodity Exchange Act, implemented a new regulatory framework for futures markets. A central feature of that framework was the replacement of prescriptive regulation with a more market-oriented approach. This new regulatory framework:

> balanced the public interests of market and price integrity, protection against manipulation and customer protection with the need to permit exchanges and other trading facilities to operate more flexibly in today's competitive environment.

65 Fed. Reg. 77,962, 77,962 (Dec. 13, 2000).

The CFMA addressed complaints of the U.S. exchanges that overly prescriptive regulation prevented them from competing effectively with non-U.S. markets.[1] The CFMA streamlined the regulatory structure by substituting a system of Core Principles and tiered regulation for prescriptive, "one-size-fits-all" regulations. It also substituted self-certification of new products and exchange rules in place of an onerous regime of prior Commission approval of all exchange rules and contracts.[2] The Commission implemented this new framework by promulgating Application Guidance and Guidance on Acceptable Practices. *See* 17 C.F.R. § 38 Appendix A and B. These new more flexible standards apply equally to existing and new exchanges.

One principal rationale for these changes was that the forces of market competition could, and would, substitute for prescriptive government regulation to protect the public interest. For example, lengthy proceedings to review proposed

---

1 *See* Review of the Commodity Futures Trading Commission's Government Performance Results Act Plan: Before the House Subcomm. on Risk Management and Specialty Crops, Comm. on Agriculture, 105th Cong. 50 (1997) (Statement of Patrick Arbor, Chairman of the Chicago Board of Trade).

2 In this regard, the Commission noted that the Chairmen of the Senate and House of Representatives Agriculture Committees encouraged this framework in order "to lessen regulatory burdens on United States futures markets so that they may compete more effectively." A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations, 66 Fed. Reg. 14,262, 14,262 (proposed Mar. 9, 2001).

exchange regulations to ensure that they did not unfairly disadvantage non-exchange members would be unnecessary if there were competitors willing and able to challenge those practices in the marketplace. Accordingly, as a corollary to the dramatic reduction in prescriptive Commission regulation, the CFMA lowered the high regulatory barriers to entry faced by new contract markets. Congress enshrined this view in the Act by amending section 3 to add as a fundamental purpose of the Act "to promote responsible innovation and fair competition among boards of trade…. "

The Exchange's application for contract market designation must be judged against this overall change in the statutory framework. It has been almost three years since Congress enacted the CFMA. During that time, the existing U.S. exchanges have been freed from unnecessary and overly restrictive regulatory impediments to their ability to ready themselves to operate in a more competitive environment. Many have taken advantage of that time to enhance their competitive positions, for example, by introducing new governance structures, new products, new lines of business, such as clearing of swaps, and new market alliances.

A number of new exchanges have tried to enter the market during this period, with a mixed record of success. While the Commission has designated six new contract markets since 2000, some of these exchanges have never listed products for trading while others have struggled to attract business. Clearly, the barriers to entry into the U.S. futures market are far more than regulatory. Despite the intent of the CFMA to rebalance the scale in favor of greater innovation and competition, the forces arrayed against the success of any new entrant remain daunting.

The CFTC's review of the application of USFE to enter the U.S. futures market in the face of opposition from certain existing exchanges is a significant test of the Commission's resolve to realize the goals of the CFMA. The CFMA will only work as Congress intended if enhanced opportunities for competition in the market exist to complement the Act's less intrusive regulatory requirements.

As set forth below, the Exchange is confident that its application clearly meets the requirements of the Act and Commission regulations when judged solely on the merits and in a manner consistent with the application of these rules and regulations to other U.S. futures exchanges.

II. INTRODUCTION TO THE APPLICATION

USFE's application for contract market designation raises no novel issues under U.S. law. The Commission has previously approved several exchanges with very similar structures and rules. The components of the Exchange are well-known to the Commission and the U.S. futures industry.

The Exchange will offer a trading platform based on the same state of the art infrastructure and network that currently is being used under license from Eurex as the electronic platform for the Chicago Board of Trade ("CBOT") and on which over 80% of the volume of U.S. fixed income futures are traded. Contracts traded on the Exchange will be cleared by The Clearing Corporation (formerly the Board of Trade Clearing Corporation) the largest clearing organization for futures in the United States. The National Futures Association ("NFA"), the leading designated futures association, will provide market surveillance and other regulatory services to the Exchange, as NFA does for other registered contract markets.

The Exchange will be a U.S.-based exchange, located in Chicago, Illinois. It will be fully subject to the jurisdiction of the United States and of this Commission. The Commission will have all the same power and authority over the Exchange that it has over any other U.S. exchange.

III. THE EXCHANGE APPLICATION IS COMPLETE AND DEMONSTRATES COMPLIANCE WITH ALL OF THE DESIGNATION CRITERIA

USFE's application satisfies the criteria for designation set forth in section 5(b) and 5(d) of the Act and the provisions of part 38 of Commission regulations. The Exchange submitted close to 2,000 pages of material, including 20 exhibits in support of its application. The Exchange has submitted signed and executed copies of a Regulatory Services Agreement with NFA and a Clearing Services Agreement with The Clearing Corporation, as well as a disaster recovery plan, various third party agreements, and extensive technical materials relating to the operations of the trading platform.

Some commentators assert that the application is incomplete because it fails to include the terms and conditions for products that it will list for trading. However, this assertion is based upon a misreading of the law. Inclusion of contract terms and conditions in the application for contract market designation is not required.

Prior to 2001, each individual product traded on a board of trade constituted a separate designated "contract market." However, the CFMA amended the statutory scheme to provide that the market as a whole is designated as a contract market. The products to be listed on the market may then be certified by the contract market after the exchange is designated. See CFTC Rule 38.4. The Exchange is not required to submit the contracts it intends to trade for prior Commission approval as part of the application process. Future contract specifications are competitively sensitive and are carefully safeguarded by all exchanges. Congress and the Commission recognized that disclosing the contracts that an exchange is intending to trade could significantly impair its competitive position and would unduly limit an Exchange's market flexibility.[3] Prior to commencement of trading, the Exchange intends to self-certify the contracts to be traded initially on its market.[4] Nevertheless, in order to facilitate the review of its application by the U.S. Department of the Treasury and the Federal Reserve Board, the Exchange has provided the contract specifications for its U.S. government securities contracts to the Commission. We understand that the entire application of USFE has been provided to the Department of the Treasury and the Federal Reserve Board for their comments.

Commentators have also suggested that the Exchange's application is incomplete because it fails to seek regulatory approval for a future clearing link between Eurex Clearing A.G. and The Clearing Corporation. These commentators nevertheless proceed to cite at great length purported regulatory issues raised by such a potential link as a basis for opposing the Exchange's application.

USFE believes that tremendous benefits will be gained by a clearing link between U.S. and European clearing organizations. A successful link could provide increased capital efficiencies, lower costs, and enhanced value and choice for customers of those clearinghouses. However, the envisioned clearing link between The Clearing Corporation and Eurex Clearing AG is neither necessary to, nor part of, USFE's contract market application. Technical and legal relationships between The Clearing Corporation

---

3 *Id.* at 14,263.

4 Designation Criterion 7 of the Act and Core Principle 7 of the Act require only that once designated and operating, the Exchange make certain information available to market participants and the public. They do not require the disclosure, for example, of the contract terms and conditions at the time of application for contract market designation. The Exchange will disclose to the public on its website and through other means the terms and conditions of the contracts it has decided to trade in advance of its launch date.

and Eurex Clearing AG relating to the link need to be studied and finalized by those organizations in consultation with their clearing members and their customers. In that connection, we welcome the creation of a committee of FIA to work with the relevant clearing organizations on the clearing link project. As this process continues, we expect that these organizations will collaborate closely with the Commission to ensure that any questions relating to a future clearing link are resolved. However, The Clearing Corporation is an independent enterprise and the process of establishing the clearing link is therefore not within our control. Accordingly, USFE does not intend to wait for this process to conclude. USFE intends to operate in accordance with the structure reflected in our application, with the Clearing Corporation as its clearinghouse. Any suggestion that the Exchange is required to delay its application and the launch of its exchange until all future features and enhancements to its operations, such as the clearing link, are ready is, of course, without merit.

The Chicago Board of Trade and the Chicago Mercantile Exchange ("CME") also complain that they have not been provided with copies of all documents submitted to the Commission in support of the application. The law does not require that an applicant for contract market designation disclose to its competitors and to the public confidential, competitively sensitive material. As prior applicants for contract market designation have done, the Exchange has sought confidential treatment for certain documents that contain trade secrets or other confidential commercial and financial information, the disclosure of which would harm the Exchange's competitive position. *See* C.F.R. § 145.5. Materials relating to the Exchange's monitoring and surveillance procedures were also filed on a confidential basis because those documents, if disclosed, could permit third parties to circumvent exchange rules or compromise the trading system's security measures. The Commission staff has properly determined pursuant to C.F.R. § 145.7(h) that the materials at issue are not subject to disclosure. These materials were all made available to the Commission and its staff. The Commission has all the necessary information to ensure compliance with the Designation Criteria.

The purpose of public comment is to aid the Commission in identifying issues of public importance relating to the application. The purpose is not to permit the Exchange's competitors to perform the role of regulator and thereby gain access to the most sensitive operational and technical aspects of the Exchange's operations. The structure and operations of the Exchange are set forth in detail in the Exchange's Bylaws, Rules, and other publicly available materials. The CBOT and the CME have been given a meaningful and unprecedented opportunity to comment on the Exchange's application and have availed themselves of that opportunity. All the application documents and

third- party contracts have been made available to the Commission and its staff. It is for the Commission, and not the Exchange's competitors, to determine if the Exchange satisfies the Core Principles set forth in the Act.

IV. FOREIGN OWNERSHIP DOES NOT PREVENT THE COMMISSION FROM DESIGNATING THE EXCHANGE AS A CONTRACT MARKET

In their comments, the CBOT and the CME suggest that foreign ownership of the Exchange raises such regulatory concerns that the Commission should not approve the USFE application. The Commodity Exchange Act, however, does not prohibit or restrict non-U.S. citizens from owning a U.S. exchange or other registered entity. To the contrary, the Commission has previously granted contract market designation to an exchange, which, at the time of the application, was 50% owned by a foreign exchange.[5] Currently, this exchange is owned entirely by a foreign-based exchange[6] and has operated as a foreign-owned U.S. contract market since July of this year. The Commission has also granted approval to a foreign-owned clearinghouse to operate as a U.S. Designated Clearing Organization.[7]

In addition, over the years, the Commission has registered numerous foreign-owned Futures Commission Merchants, Commodity Pool Operators, or Commodity Trading Advisors. These registrants assume significant regulatory obligations under the commodities laws and often have regular and direct contact with the U.S. retail public.

---

[5] On August 22, 2001, the CFTC designated NASDAQ/LIFFE as a contract market under the Commodity Exchange Act. NASDAQ/LIFFE was originally a joint venture of the Nasdaq Stock Market and the London International Futures and Options Exchange ("LIFFE"). *See* Designated Contract Markets Registered with the CFTC, *available at* http://cftc.gov/dea/deadcms_table.htm (last modified Sept. 22, 2003).

[6] The exchange is wholly owned by Euronext.Liffe, owner and operator of derivatives exchanges in Amsterdam, Brussels, Lisbon, and Paris. *See* NQLX website, *Overview of NQLX, available at* http://www.nqlx.com/aboutnqlx/aboutnqlxoverview.asp; *Euronext.Liffe to Take Over Ownership of NQLX*, Euronext.Liffe News Release, June 26, 2003, *available at* http://www.liffe.com. The transfer of ownership interests was effected pursuant to Commission Rule 40.6.

[7] The London Clearinghouse was designated by the CFTC as a Clearing Organization on October 29, 2001. *See* Order of Registration, *In the Matter of the Application of the London Clearing House for Registration as a Derivatives Clearing Organization, available at* http://www.cftc.gov/files/opa/press01/opaorder10-26.pdf (Oct. 29, 2001).

We are unaware of any problems that have arisen as a result of foreign ownership of these entities and the CBOT and CME have cited none in their comments.[8]

Indeed, Eurex Frankfurt AG and its predecessors have had trading terminals in the United States and have been offering their products to U.S. customers since 1996 without incident. The CBOT and CME have opposed the placement of foreign terminals in the United States, contending that foreign exchanges should be required to obtain U.S. contract market designation and comply with the same legal requirements applicable to U.S. exchanges. Having now sought to do so, USFE faces the argument that it should not be designated as a contract market due to its foreign ownership. This sort of "heads I win, tails you lose" approach lays bare the real motivation of these commentators – not regulatory concerns, but foreclosing potential competition.

The regulatory "concerns" that have been identified are entirely speculative and unfounded. The interests of the Exchange do not conflict with the national interests of the United States. Rather, as noted above, the public interest is furthered by competition in the provision of exchange services. For example, real competition in the market for U.S. Government Securities futures offers the potential to lower the financing costs of the U.S. Government.

Foreign ownership does not affect USFE's ability to offer a safe environment for trading contracts in U.S. Government Securities. Indeed, it is instructive to note that the principal liquidity providers for U.S. Government Securities are the Primary Dealers.

---

[8] The CBOT's reference to certain special rules governing foreign ownership for nuclear power facilities, air carriers, maritime shipping, and even banks only highlights how rare it is for Congress to limit or restrict foreign investment in U.S. businesses. Despite frequent legislative focus on the globalization of the derivatives business in the last two decades, Congress has wisely never concluded that limiting foreign competition in the futures business is in the best interests of the U.S. public.

Bank regulation is easily distinguishable in that banks take federally insured deposits from the general public. In any event, as the public comments reveal, the principal regulatory requirement applicable to foreign owners in the banking arena is the requirement of effective oversight by the foreign bank's home country regulator – a requirement that would be readily satisfied here. *See* Order dated May 8, 2002, 67 Fed. Reg. 30785, granting 30.10 relief to designated Eurex members in which the CFTC staff necessarily determined that the German regulatory scheme was "comparable" to that existing in the United States and that the German regulator had entered into appropriate information sharing agreements with the United States.

The Primary Dealers are authorized by the Federal Reserve Bank of New York to buy and sell Government Securities directly from the Federal Reserve Bank. A majority of the institutions chosen by the Federal Reserve Bank of New York to act as Primary Dealers are affiliates of foreign-owned companies.

Moreover, imagined "conflicts" between USFE and U.S. governmental interests bespeak confusion concerning the nature of contract markets. Futures exchanges provide a neutral forum for market participants to come together and transact business. The Exchange itself does not trade the products it offers nor does it set monetary policy. Its paramount interest is in offering fair, orderly and efficient markets. Eurex has a well-deserved reputation of working cooperatively with regulators in each of the jurisdictions in which it operates to ensure its compliance with local law and to protect the integrity of its marketplace. Any suggestion that the interests of USFE in complying with U.S. law, in enforcing its rules or in cooperating with the Commission are different from other U.S. contract markets is utterly baseless and more the product of prejudice or the desire to foreclose competition than logic or experience.

In addition, even the meaning of "foreign ownership" itself is unclear and its relevance highly questionable. For example, the CME has recently concluded an initial public offering of stock and as a public company undoubtedly has some degree of foreign ownership. There is nothing in U.S. securities laws or the Commodity Exchange Act that would prevent foreign-based individuals or institutions from purchasing a majority of the stock of CME. By contrast, Deutsche Boerse AG, which indirectly holds a 50% equity stake in Eurex, is majority owned by U.S. and UK investors with a U.S. fund manager being its largest shareholder. In light of the ease in which investment capital flows across borders, any attempt to draw conclusions about the future conduct of an exchange based on "foreign ownership" is inherently suspect.[9]

---

[9] As a further attempt to use "foreign ownership" as a means of opposing the current application, one commentator has sought to create the impression that U.S. exchanges would be prohibited from establishing an exchange in Germany. This conclusion is based on the statement of a single lawyer in Germany that the state supervisory authorities in Germany *could* in their discretion consider whether an additional exchange was necessary or appropriate in deciding whether to admit a new entrant. Tellingly, the German lawyer does not opine that state authorities *would be likely* to consider that factor or that there is any precedent for state authorities rejecting an application of a foreign exchange on this or any other basis. The facts belie the commentator's conclusion. German exchange regulators have permitted the licensing of

Footnote continued on next page

Regardless of the nationality of its ultimate shareholders, the Exchange is required to operate in accordance with rules and bylaws that are approved by the Commission as part of the contract market designation process. The Exchange will be managed by officers based in Chicago and it will be governed by its Board of Directors. The actions of the Exchange and its Board will be subject to review by the Commission. Its books and records will be located in the United States. The Commission has the right to review and investigate Exchange operations, and the Commission conducts periodic rule enforcement reviews of every designated contract market as a matter of course. In the unlikely event the Commission determines that the Exchange is not enforcing its rules or is otherwise violating the Act or Commission regulations, it may suspend or revoke the Exchange's designation. *See* Section 6(b). The Commission may also enter a cease and desist order or fine the Exchange up to $500,000 for each violation of the Act. In short, the regulatory scheme provides a powerful incentive for the Exchange to comply with all applicable legal requirements and grants the Commission ample authority over the Exchange to ensure that compliance.[10]

Footnote continued from previous page
a Nasdaq-controlled NASDAQ Deutschland AG stock exchange to trade securities products in competition with other exchanges. There are no restrictions on foreign ownership of German exchanges and the licensing criteria applied by German regulators are, in fact, quite similar to the standards applied under U.S. law. Finally, even if all sixteen German state regulators were to impose restrictive conditions on an exchange applicant in their jurisdictions, under principles of EU law, a U.S. exchange could operate in Germany based on a license received from any other member state within the European Union. Article 15(4) of the Investment Services Directive. *See also*, *Towards a Single Market in European Securities Trading: An Agenda for Reform of the ISD*, The Centre for European Policy Studies (June 12, 2000) *available at* http://www.ceps.be/Research/ESFRC/12jun00.php.

[10] Emergency action by the Exchange is no different. Under Exchange Rule 804, the Chief Executive Officer based in Chicago has the discretion to take emergency action on behalf of the Exchange. The Commission must be promptly notified of any emergency action taken and is in a position to ensure that such action is appropriate. *See* Section 8a(9) of the Commodity Exchange Act (authorizing the Commission in an emergency to "take such action as in the Commission's judgment is necessary to maintain or restore orderly trading….").

V. EXCHANGE GOVERNANCE WILL COMPLY WITH CORE PRINCIPLES

Commentators raise a number of issues relating to the Exchange's governance structure primarily based on the assumption that the Exchange intends to operate with a single director. However, as the Exchange represented to the Commission, it will not, and never had the intention to, operate with a single Board member. In accordance with the Exchange's Articles of Incorporation and Bylaws and prior to the commencement of trading, the Board of Directors will be expanded, most probably to twelve Directors. Overall the Board composition will be balanced, including representatives of all segments of Exchange participants.[11]

The Board will comply in all respects with applicable U.S. law. As required for all U.S. exchanges, the Exchange will conduct an independent inquiry to substantiate the fitness information that directors will be asked to provide, including verification of fitness using the BASIC and other similar databases. Directors will be asked to certify that they meet the Exchange's fitness standards and these certifications will be provided to the Commission.

VI. CONCERNS ABOUT INSIDER TRADING ARE UNFOUNDED

Exchange Rule 207 prohibits officers and employees of the Exchange from trading on the Exchange or in any related contracts. Board members and employees of any Eurex U.S. affiliate providing regulatory services to the Exchange are barred from trading on material nonpublic information obtained through the performance of their duties for the Exchange. The Exchange will obtain commitments from employees of affiliates performing regulatory services that they will not trade on inside information and these employees will consent to Commission jurisdiction to enforce that agreement. As noted above, the Exchange and NFA have ample incentive to ensure compliance with these rules. Of course, issues relating to insider trading are of far less concern (and compliance is far less difficult) when – as is the case here – the contract market is owned and controlled by neutral and independent exchange operators, rather than by traders, as is the case with many U.S. exchanges.

---

[11] The Act does not prohibit non-U.S. citizens from serving on the board of a U.S. exchange or other registered entity and it is not unusual for non-U.S. citizens to do so.

VII. A COST-BENEFIT ANALYSIS IS NOT REQUIRED

The Commission is not required to conduct a cost-benefit analysis prior to approving a contract market designation. The process and criteria for contract market designation is specifically addressed by Congress in Sections 5(b) and 6 of the Act. These sections set forth the criteria that must be met in order for contract market designation to be granted. No additional finding is required. Because the standards for contract market designation appear in Sections 5(b) and 6 of the Act and implementing regulations, to our knowledge, the Commission has never conducted a cost-benefit analysis pursuant to Section 15 for any previous contract market application. Nor has the Commission concluded that a cost-benefit analysis is required when approving Exchange rule changes or contract terms and conditions.[12]

VIII. THE EXCHANGE'S INCENTIVE PRICING PLANS WILL BE CONSISTENT WITH THE ACT

The CBOT and the CME attack the Exchange's pricing based on information contained in its preliminary marketing material, claiming that the Exchange intends to pay for order flow and encourage noncompetitive pricing. In fact, while the Exchange has not finally decided upon its pricing and incentive plans, the Exchange has never suggested (and will not be) paying for order flow as that term is commonly understood. It will be adopting volume discount and revenue rebate plans that reduce the costs of transacting business on its market. These plans are similar to the programs utilized by existing U.S. exchanges, including the CBOT and CME. These plans have been approved by the Commission and subsequent to the CFMA routinely self-certified or implemented by notice to the Commission.

Charges of improper "European-style pricing" are not new. The CBOT and CME have made similar allegations in the past and the CFTC staff has rejected them. For example, in June 1999, the CME, the CBOT, and NYMEX submitted a joint petition to

---

[12] In the unlikely event that the Commission concludes that it must consider the costs and benefits under Section 15 of approving the Exchange's application, this hurdle is easily overcome. The materials submitted in the application demonstrating compliance with the designation criteria also evidence the benefits that the Exchange will bring to the market. The Commission can readily conclude that by satisfying the Core Principles, the Exchange will provide a safe and effective marketplace for trading of futures products, while promoting the statutory goal of furthering innovation and competition in the industry.

the Commission for exemption from certain statutory requirements. The exchanges claimed that U.S. contract markets might be disadvantaged by foreign exchanges' alleged ability to pay for order flow. The CFTC staff dismissed the domestic exchanges' charge, noting that payment for order flow is not prohibited by the Act and that the Commission has approved various incentive payment programs at the CME, CBOT, and NYMEX. The staff stated that the programs used by the domestic exchanges "often provide market makers or other trading entities with monetary compensation either as a flat 'retainer' whereby the market maker is paid a fee for its presence in the trading pit, as a discount on trading volume that meets or exceeds certain specified thresholds, or as a payment per transaction." *See* Memorandum from the Division of Trading and Markets to the Commission, Aug. 4, 1999.

Since the enactment of the CFMA, the domestic exchanges have continued to adopt various incentive programs, particularly when introducing new contracts.[13] Pricing

[13] Examples of incentive programs adopted by the domestic exchanges since enactment of the CFMA include:

- NYMEX liquidity incentive program for the e-miNY crude oil or natural gas futures contract which waives fees and pays $0.25 per contract for trades which result from standing orders of five seconds or more. (Announced Oct. 1, 2002).
- NYMEX agreed to waive all clearing and exchange fees for its new Brent crude oil futures contract for the first year of trading and to offer rebates for three months on any light, sweet crude futures contract traded to offset a position in the Exchange's Brent futures contract. (Announced Apr. 17, 2001).
- CME adopted and extended its Lead Market Maker ("LMM") program to additional contracts, including offering it for the Weather futures contract in March 2002. The LMM program offers trading and financial incentives to Lead Market Makers.
- CME implemented a GLOBEX system fee waiver for all foreign exchange transactions executed via the GALAX-C handheld device and a GLOBEX Member Incentive Program which offers volume discounts at thresholds of 50,001. In August 2003, the CME announced three new initiatives to increase the appeal of electronic trading. The initiatives include reducing customer fees and establishing a market maker program for Eurodollar futures traded on GLOBEX.

Footnote continued on next page

incentives are considered commonplace when launching a new market. Revenue sharing or market maker incentives are used to reward liquidity providers and early supporters of the market. The practice is used throughout the United States, including at the CBOT in its mini-Dow, Swaps, Swap Options, and two-year Treasury note product launches. These practices enhance competition and reduce costs for market users.[14]

IX. THE EXCHANGE'S MARKET TRANSPARENCY, TRADING FAIRNESS AND OVERSIGHT RAISE NO REGULATORY CONCERNS

The CBOT and CME express concern about pricing transparency, trading procedures and regulatory oversight of the market. However, there is no dispute that the Exchange trade matching system will be extremely transparent and fair. The Exchange Trading System will be based on the Eurex Trading System, which is currently licensed for use by CBOT. The Eurex Trading Platform offers all users a fair and transparent market. Members do not have any special access to trade information and no member has an informational advantage over any other member arising from the trading platform. Because of the strength of the trading platform in providing market participants with a fair and transparent market, the CBOT and CME focus their criticisms on off-order book trading functionalities. These include the trading facilities for Basis Trades (EFPs), Block Trades, and Exchange of Futures for Swaps.

These Exchange off-order book functionalities are consistent with the rules and practices of other U.S. exchanges. For example, one commenter states that the Block Trading rule does not comply with the "fair and reasonable pricing standard,"- a standard

---

Footnote continued from previous page

- The CBOT adopted an a/c/e one-for-one fee credit program which provides a member transaction fee waiver for each contract executed on a/c/e/ where a like contract, within the same product complex, is executed in the open auction market on the same trading day.

[14] The CME also argued that the SEC has criticized payment for order flow programs. As noted above, the Exchange will not be paying for order flow. However, even with regard to payment for order flow, the SEC has repeatedly permitted its regulated exchanges to offer such programs noting that any concerns can be addressed by appropriate disclosure. A number of securities exchanges are currently offering significant payment for order flow programs. The SEC has previously recognized potential benefits of such payment programs, such as cost savings to customers, faster execution, enhanced services, and increased competition. *See* SEC Release 34-33,026 (Oct. 6, 1993) at Section III.F.

that the Commission determined not to include in its guidance of acceptable practices under Core Principle 9. *See* 17 C.F.R. § 38, Appendix B, Core Principle 9(b). Moreover, the Exchange's Block Trading Rule limits pricing discretion by providing that the prices must be within the day's trading range in contrast to other U.S. exchanges (including one of the commenters) that simply leave pricing completely to the discretion of the traders.

The commenter also raises concerns that the Exchange's option trading functionality will be mostly an "OTC" market. However, even if true, there is nothing in the Act or Commission rules that calls into question the legitimacy of such a market. Billions of dollars in equity and fixed income options are transacted in this country in the OTC market. Due to current limitations in executing complex option strategies on screen or for other reasons, market users have obviously determined that there is value in doing business in this way. The Commission explicitly recognized that designated contract markets should be permitted to offer such trading and to clear it through a designated clearing organization. *See* Appendix A to Part 38, Designation Criterion 3 (providing that a contract market's rules may authorize off-order book transactions). Indeed, one of the fundamental purposes of the CFMA was to "reduce systemic risk by allowing the clearing of transactions in over-the-counter derivatives." *See* Section 2(7) of the CFMA.

Nevertheless, it is not the Exchange's intention that its market in options bypass the order book. The Exchange has every incentive to move this business to the trading platform. Indeed, the Exchange is excited to be offering on its trading system a number of innovative, advanced technological functionalities that will make option trading on an electronic platform attractive. Accordingly, the Exchange expects that its electronic trading platform will provide a deep, liquid market that will be competitive with existing option markets.

Finally, the commenters raise questions regarding the Exchange's program for market oversight. The Exchange has contracted with the NFA to conduct market, financial, and trade practice surveillance. The NFA is widely recognized as the leading provider of outsourced self regulatory services to U.S. futures exchanges. The Commission has previously approved the use of NFA to provide regulatory services to exchanges on four separate occasions. The Commission staff has also recently conducted a rule enforcement review of NFA's market and trade practice surveillance for another exchange and concluded that it had adequate programs in place to monitor those markets.

In accordance with Designation Criterion 2 and Core Principle 4, the NFA, together with the Exchange's own staff, will monitor trading to prevent manipulations, price distortions, and disruptions of the delivery or cash settlement process. The NFA

will, among other things, review large trader reports and analyze open interest, deliverable supplies, price changes in the marketplace, and other relevant data. The NFA will also utilize a sophisticated automated system to detect potential trade practice violations such as trading ahead, front running, wash trading, and other abusive practices.[15]

The Exchange has also contracted with corporate affiliates to carry out a number of non-regulatory functions. There is nothing improper about the Exchange's third-party agreements with these affiliates. The Exchange has contracted to receive certain software development, maintenance, and network services relating to the trading platform, as well as certain accounting and corporate services. The Exchange has also agreed to outsource the marketing and distribution of Exchange market data. Neither the Act nor Commission regulations prohibits these outsourcing agreements and indeed these services were among the services that were outsourced to Eurex by CBOT in connection with the operations of the a/c/e/ system.[16] There is no inherent advantage to an exchange structure that performs these functions within the corporate body of the exchange. The CFMA clearly rejects this sort of "one-size-fits-all" model of contract market structure and regulation. To limit an exchange's ability to outsource functions that can be done more efficiently and more cheaply by others would only increase costs, reduce innovation, and discourage measures to improve exchange efficiencies.[17]

X. CONCLUSION

USFE is grateful for the support it has received from market users and other commentators for its application to become a U.S. designated contract market. The comments of the exchanges that oppose USFE's application would have the Commission return to the days when the government - and not the marketplace - determined whether

---

[15] While NFA will have unprecedented access to information on European products, issues raised by commentators relating to the need for surveillance coordination with foreign exchanges and foreign regulators with respect to cross-listed products that will not be traded until the clearing link is implemented are premature.

[16] As the Commission explicitly noted, because the Exchange has retained decision-making authority, none of these relationships would constitute a "delegation" of authority under the Act requiring that the delegee itself be a registered entity. *See* 66 Fed. Reg. at 42,266. Indeed, the Commission specifically noted that functions such as operation of a matching engine could be outsourced by contract to a non-regulated entity. *Id*. at n.58.

[17] A detailed discussion of specific rules of USFE is attached.

new and innovative ways of doing business added value to market users; when "one-size-fits-all" regulations demanded that exchange rules and operations conform to a single model; and when the demands of market participants were stifled by a "government knows best" approach to exchange regulation.

The CFMA implemented a new paradigm for the regulation of futures markets. It streamlined regulation and promised greater innovation and competitive opportunities. The CFTC faithfully implemented the CFMA by promulgating the Application Guidance and Guidance on Acceptable Practices. USFE filed its application in accordance with these new guidelines and precedents. The Exchange has responded to all questions raised by the Commission with respect to its application. No issue raised by the CBOT or the CME casts serious doubt on the Exchange's compliance with the Act's designation criteria. In keeping with the goals of the CFMA, the Exchange is poised to offer U.S. market participants and the U.S. consumer the benefits that greater competition and innovation will bring to the futures industry. Moreover, the Exchange will do so within a framework of financial integrity and customer protection provided by the U.S. regulatory structure and demanded by market users. For these reasons, we look forward to a timely approval of our application for contract market designation and will continue to work with the Commission to address any question that may come up in connection with our application.

Sincerely,

Michael McErlean
Director
U.S. Futures Exchange, L.L.C.

ATTACHMENT 1—DETAILED DISCUSSION OF RULES

The Board of Trade of the City of Chicago and the Chicago Mercantile Exchange have leveled a significant number of criticisms against U.S. Futures Exchange, L.L.C.'s (USFE) rules. As the following discussion details, these criticisms are unfounded, or are based upon a misapprehension of the Trading System or of the rules themselves.

Financial Integrity

USFE Rules 302 and 307; Minimum Financial Standards: (CME Comment Letter: Attachment C at 6). USFE's rules provide the model for meeting Designation Criterion 5 relating to Financial Integrity of Transactions. Rule 308 requires that Members comply with CFTC regulations, including Commission Rule 1.17. Rule 307 requires that members maintain financial resources at a level prescribed by the Exchange. Non-clearing members must have an agreement in place with an authorized clearing member in order to trade. In addition, consistent with the structure of the CFMA, which regulates clearinghouses separately from exchanges, The Clearing Corporation (C Corp) - a well-established and highly regarded designated clearing organization - will set financial standards for its clearing members.

USFE Rule 405; Confirmations and Objections: (CME Comment Letter: Attachment B at 2). C Corp will accept trades matched by the Trading System at the time of match. Accordingly, the possibility of a scenario suggested by the commentators that customers will learn belatedly or not at all of a challenge to a particular trade, is remote. In such an instance, disputes between clearing members will be resolved in accordance with C Corp's rules. *See* USFE Rule 405.

USFE Rule 308; Margins and Member Defaults: (CME Comment Letter Attachment C at 6. In addition to USFE rules, Members must comply with CFTC requirements, including the specific requirements applicable to the protection of customer funds. C Corp also addresses issues relating to protection of customer funds by rule. *See* e.g. C Corp Rule 312.

USFE Rule 506; Margins and Member Defaults: (CME Comment Letter Attachment C at 6-7. C Corp establishes collateral and margin policies. See e.g. The C Corp Rules, Part 4 (Margin and Settlements). The Exchange also reserves the right to require its members to collect additional margin from customers, and both C Corp and the Exchange have ample authority to effect a transfer of positions in the event of a member default. Rule 804, for example, provides that when a member has failed to perform on any contracts or may be insolvent, the CEO of the Exchange may order the transfer of positions from one member to another. *See also* The Clearing Corporation Rule 605. As the above rules demonstrate, the joint efforts by USFE and C Corp. will provide a level of financial protection second to none in U.S. derivatives markets.

Fair and Transparent Trading Platform

USFE Rule 307 (j); Priority of Customer Order Entry: (CME Comment Letter: Attachment D at 8). Many of USFE's rules are written specifically to reflect the exchange's forward-looking, all-electronic environment. Thus, for example, as the Exchange application makes clear, a person cannot technically access the Exchange system without a terminal operator identification.

Rule 403(a)(i); Business Day Periods: (CME Comment Letter: Attachment B at 2). Rule 403(a)(i) provides that, except as otherwise provided, all transactions involving Contracts must be transacted through the Trading System. "Trading System" is a defined term. "Orders" and "Quotes " are driven by the Trading System's interactive windows and are thereby defined.

USFE Rule 506; Order Types**:** (CBOT Comment Letter at 29). The trading system provides for and captures all required CTI codes through operation of the Trading System.

USFE Rule 408; Cancellation of Transactions: (CME Comment Letter: Attachment B at 4). USFE also provides a rule on trade cancellation that provides a high degree of certainty with regard to the conditions under which trades will be cancelled. The Exchange's cancellation rule is both sensible and fair and has been developed after consultation with market participants. The determination of the time within which a member must report an error is a matter of discretion for the exchange and is clearly within the range of acceptable practices. The rule does not permit traders to execute counter transactions. Such counter transactions are entered by Market Supervision staff.

Customer Protection

USFE Rule 307(n); Priority of Customer Order Entry: (CME Comment Letter: Attachment D at 8). USFE also will provide a high degree of protection to its customers, both through its rules and through established principles of agency law. For example, under agency law, a member could be liable for front-running whether it acted directly or through the actions of its agent or employee.

Rule 307(n); Cross Trades and Pre-arranged Trades: (CME Comment Letter: Attachment B at 2-3). In addition, Members have a duty to give priority to entry of

customer orders in all instances, including when orders are crossed under Rule 406. Accordingly, the customer order will have priority in each instance and will be exposed to the order book.

Off-order Book Functionalities

USFE Rule 418; (CBOT Comment Letter at 29). The Eurex US System includes a number of off-order book functionalities which tie together exchange-traded instruments and off-exchange liquidity pools. These provisions are consistent with the letter and intent of the CFMA's provisions. For example, under Rule 418 all transactions entered using these functionalities, including the Volatility Trading Facility, will be presented for clearing to C Corp.

USFE Rule 415; Block Trading: (CME Comment Letter: Attachment B at 5). Moreover, the pricing information from block trade transactions will provide additional price discovery opportunities to the markets. USFE Rule 415 provides that the prices of block trade transactions will be provided to "Members." "Members" refers to all Members, not merely those involved in the transaction. Accordingly, block prices will under the rule's provisions, be published to the market. Moreover, the pricing information provided will have a higher value to the market because the pricing requirement of the rule limits pricing discretion more than the CME's own block trading rule.

USFE Rules 416-417; EFPs & EFSs: (CBOT Comment Letter at 29). Although the commentators have suggested otherwise, limitation on the creation of new open interest through EFPs or EFSs is most necessary with respect to Contracts with very limited deliverable supplies. Commodities with large deliverable supplies, such as those to be traded by USFE, should not be subject to disorderly expirations. USFE's rules relating to EFPs and EFSs are consistent in this respect with rules previously approved for other exchanges trading liquid commodities such as financial futures.

USFE Rule 403(e); Average Price Trades: (CME Comment Letter: Attachment B at 2). Rule 403(e) relating to "Average Price Trades" incorporates by reference the

requirement that the practice is "in accordance with the then current requirements of the Commission."

Position Limits

USFE Rule 413; Exemptions from Position Limits: (CME Comment Letter: Attachment B at 4). USFE's rules are also forward looking by providing the Exchange with authority that is not currently applicable based upon its immediate marketing plans. For example, although USFE rules provide the authority to impose exchange position limits, it plans to begin trading in contracts that are more commonly the subject of position accountability rules. Nevertheless, USFE has the flexibility to impose speculative position limits and if it does so, it will differentiate the nature of the exemption being requested.

USFE Rule 414; Position Accountability: (CME Comment Letter: Attachment B at 5). Rule 414 authorizes USFE to impose position accountability rules. Subsequent implementing rules of the Exchange will be submitted to the Commission as required under 17 CFR Part 40.5 or 40.6 with respect to the particular contracts traded. The authorizing rule need not incorporate Commission standards in its text. Rather, the implementing rules with respect to particular contracts must meet Commission standards. USFE's implementing rules for particular contracts will do so.

Recordkeeping

USFE Rule 307(d); Commission Recordkeeping Requirements: (CME Comment Letter: Attachment D at 8). In many respects, USFE rules dovetail with, and build upon, CFTC rules and requirements. For example, Core Principle 10 requires that the Exchange retain records identifying trade information. The Exchange will comply fully with this record-keeping requirement and Commission Rules 1.31 and 1.35. Moreover, both Rule 307 and Commission regulations address the obligations of members and FCMs to retain records regarding the terms of all transactions executed on the Exchange and specify the types of materials to be maintained. Accordingly, the Exchange has established a record-keeping obligation for itself and its members which is fully in line with regulatory requirements.

USFE has proposed rules which reflect the new structure put in place by the CFMA. The rules are modern, forward-looking and, as the above discussion illustrates, fully consistent with all legal requirements.