THE APPLICATION FOR CONTRACT MARKET DESIGNATION OF THE U.S. FUTURE EXCHANGE, LLC BEFORE THE COMMODITY FUTURES TRADING COMMISSION

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

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THE APPLICATION FOR CONTRACT MARKET DESIGNATION OF THE U.S. FUTURE EXCHANGE, LLC BEFORE THE COMMODITY FUTURES TRADING COMMISSION

THURSDAY, NOVEMBER 6, 2003

HOUSE OF REPRESENTATIVES,
COMMITTEE ON AGRICULTURE,
Washington, DC.

The committee met, pursuant to call, at 10:10 a.m., in room 1300, Longworth House Office Building, Hon. Bob Goodlatte (chairman of the committee) presiding.

Present: Representatives Boehner, Pombo, Smith, Lucas of Oklahoma, Moran, Jenkins, Gutknecht, Ose, Johnson, Osborne, Rehberg, Janklow, Burns, Rogers, Neugebauer, Stenholm, Peterson, Dooley, Etheridge, Hill, Baca, Alexander, Ballance, Scott, Marshall, Pomeroy, Boswell, Lucas of Kentucky, Udall and Larsen.

Staff present: Dave Ebersole, senior professional staff; Brent Gattis, Ryan Weston, Callista Gingrich, clerk; Kelli Ludlum, Teresa Thompson, and John Riley.

OPENING STATEMENT OF HON. BOB GOODLATTE, A REPRESENTATIVE IN CONGRESS FROM THE COMMONWEALTH OF VIRGINIA

The CHAIRMAN. Good morning. This hearing of the House Committee on Agriculture to review the application for contract market designation of the United States Futures Exchange LLC before the Commodity Futures Trading Commission will come to order.

The committee meets this morning to review the substance and process of the pending application of U.S. Futures Exchange, also known as Eurex U.S., to operate a futures exchange in Chicago.

Since Eurex U.S. filed this application with the Commodity Futures Trading Commission in mid-September, it has generated a great deal of controversy. The application also has generated legitimate questions about public policy in the area of derivatives regulation, and this comes just 3 years after the President signed the Commodity Futures Modernization Act on December 21, 2000. At that time, the CFMA was widely described as a milestone in sensible deregulation. I hope this hearing is not building the foundation for reregulating the derivatives market in this country.

This proposal has stirred a pot of legitimate concerns and questions about the CFTC's due diligence concerning the application and public interest in keeping the process fair and open and our markets orderly.

Among those questions are the following: Is the application incomplete because it does not reveal, at least not publicly, the contracts Eurex U.S. will trade if the CFTC designates the exchange as a contracted market?

If approved, will Eurex U.S. offer cross-border clearing and settlement procedures that could potentially harm the public interest? And, though apparently not contained within the original application, what is the process for offering such services in the future?

Does the National Futures Association, a CFTC-regulated futures association, have the capability to carry out regulatory services for Eurex U.S., and what is the standard the CFTC uses to make that determination?

Has the CFTC informed the Department of the Treasury and the Federal Reserve that Eurex U.S. plans to offer U.S. Government securities as a part of the contract market designation application process required by the Commodity Exchange Act? And, more basic to that question is the one asked a moment ago: Is Eurex U.S.required to list futures and option contracts it will trade prior to designation as a contract market?

Who runs Eurex U.S., and who is responsible for its operation?

And, finally, to satisfy my own curiosity, does the German Government reciprocate by offering a licensing process similar to that availability through the CFTC under the Commodity Exchange Act? And is that process easily implementable?

Some of the questions have been answered in a letter Chairman Newsome sent to me on October 27, 2003, in response to a set of questions I asked the CFTC.

From a reading of the testimony the committee will hear this morning and the comment letters the Chicago exchanges submitted during the CFTC's notice and comment period on the Eurex U.S. application, I think there are many questions that remain to be answered. I hope we are able to answer most of them today.

It is now my pleasure to recognize the gentleman from Texas, the ranking Democrat, Mr. Stenholm.

OPENING STATEMENT OF HON. CHARLES W. STENHOLM, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. STENHOLM. Thank you, Mr. Chairman. Thank you for holding this timely hearing. It is an exciting day here at the Agriculture Committee, and the issue before us promises to be a lively one.

Mr. Chairman, last year the world's futures and options exchanges traded nearly 6 billion contracts. Over 500 million of those were traded at the Chicago Mercantile Exchange, over 300 million at the Chicago Board of Trade and just over 801 million on Eurex. We have before our committee today the worldwide heavy hitters of exchange-traded derivatives.

Our gain today is Chicago's loss, by the way. Dow Jones reports that this hearing has stolen just a little of the thunder from the Annual Future Industries Association Expo, which is going on in the Windy City right now. That story describes Eurex as the elephant in the corner, but the Chicago story we hear today may be that Eurex is really the Trojan horse, a gift of liquidity, fairness, open access and modern efficiency that disguises a hidden attack

on integrity and fair pricing. In the Eurex story all they want to do is to bring low-cost trading to an American market. Some may even suggest that there is an element of competition involved in the discussion we are hearing today.

We also have the Commodity Futures Trading Commission, which for the moment at least is the gold standard of the financial market regulation throughout the world for sure, but especially here in the United States where its sister agencies are consumed with governance and accounting crises, not true today in the Commodity Futures Trading Commission. Through its active involvement with the International Organization of Securities Commissions, the CFTC continues to lead an international cooperation in regulatory innovation.

Mr. Chairman, this hearing provides us the opportunity to witness the task faced by the Commission in a debate that calls on it to define and refine, as you have stated in your opening comments, Mr. Chairman, define and refine key aspects of the Commodity Futures Modernization Act which was enacted nearly 3 years ago.

Clearly, one goal of the Act was to allow exchanges, new and old, to bring innovative ideas to the marketplace by allowing for more flexibility for market participants to innovate. The Act also necessarily compels the Commission to define anew its charge to preserve the integrity of markets, and our sister agencies today now are under fire because of their lack of doing that.

Mr. Chairman, the CFTC has a difficult task, given the issues brought before it by the Eurex U.S. application, and it will be important for us to pay close attention to its deliberations. The hearing today and our excellent panel of witnesses will certainly help us to see more clearly what the real-world impact of the CFMA is going to be. The entire situation is as much a test of the Act as it is of the CFTC.

Again, thank you, Mr. Chairman, for convening this important meeting of the committee.

Mr. MORAN [presiding]. Thank you very much, Mr. Stenholm.

Mr. Goodlatte, I understand you have duties on the House floor. We welcome you back at your earliest opportunity.

I would like to take a moment to make a brief opening statement.

OPENING STATEMENT OF HON JERRY MORAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF KANSAS

Mr. MORAN. First of all, thank all the witnesses for their appearance before our committee today.

The Commodity Futures Trading Commission and the futures industry are an important part of the oversight of this Agriculture Committee and specifically the subcommittee that I am honored to chair. In June, our General Farm Commodities and Risk Management Subcommittee held a series of hearings on the implementation of CFMA. I think we heard a number of topics and discussion about current issues from the regulatory perspective, as well as the views of the industry as far as tact and overall competitiveness in the industry. I think at an initial glance during that series of hearings it appeared that CFMA had accomplished much of its intended

purpose, regulatory relief to foster industry growth, while still protecting market integrity for all participants.

In the 3 years since the passage of CFMA, the futures markets have developed and traded more than 790 million contracts last year. Yet despite the successes of CFMA, there are concerns that remain about fairness of the global playing field among U.S. exchanges, electronic markets, over-the-counter markets and international firms.

Today we have the opportunity to more closely examine another particular facet of CFMA, the process for designation of new contract markets. The Eurex U.S. application provides an opportunity for members to become more familiar with the new regulatory approval process by reviewing the status of this particular application now pending at CFTC.

With regard to contract market designation, it is my hope that this hearing will help clarify whether we have in fact achieved the right balance of self-regulation and minimal Government oversight or whether additional steps are needed to ensure market integrity of the competitiveness of the U.S. futures industry.

Other members of the committee, you are welcome to make opening statements as part of the record.

[The prepared statements follow:]

PREPARED STATEMENT OF HON. JOHN A. BOEHNER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Thank you, Mr. Chairman. As long as I have been a member of this committee, I have diligently championed and defended a free-market, free-enterprise approach to the policy discussions this committee has engaged in including farm bill rewrites and the sweeping regulatory changes made by the Commodity Futures Modernization Act.

I strongly supported the CFMA and I continue to support its merits. The Commodity Futures Trading Commission is stocked with talented people who are extremely capable of overseeing the self-policing and self-regulatory futures industry features that made CFMA a model of market regulatory law which was designed to allow competition to flourish.

The purpose of this hearing today is not to undermine the tenets of CFMA or to begin backtracking on the promises made by that landmark legislation. The purpose of this hearing is to fulfill our Congressional oversight responsibility to make certain that the designated contract market application submitted by Eurex U.S. for the U.S. Futures Exchange satisfies all of the designation criteria, the CFTC's core principles and our expectations for market transparency and integrity.

Eurex is one of the world's leading futures exchange and I would suggest that its application to do business here in the U.S. is itself a novel issue. However, with passage of CFMA we recognized that global competition is good for all stakeholders and especially customers and therefore we welcomed it.

Now, without standing in the way, we must ensure that global competition is fair and that all customers are adequately protected in an industry that prides itself on innovative products and innovative ways to trade those products.

Before and after many of the well-publicized corporate financial collapses of recent years, the House Education and Workforce Committee, which I chair, has invested considerable time in examining customer protections and conflict of interest in the business models of investment advice companies to ensure investment integrity for our Nation's workforce. Similarly, I believe this committee and this hearing can provide further examination of the Eurex business model so that Eurex can discuss their business plans and so that all stakeholders can publicly air their concerns to ultimately preserve the market integrity of the futures industry.

CFMA gave unprecedented latitude and flexibility to the futures industry and to futures regulators and I believe it has succeeded. But to continue that success, when new issues arise, Congress and the CFTC must take the opportunity to do our jobs by ensuring customer protection and market integrity without hindering global competition.

PREPARED STATEMENT OF HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Thank you Mr. Chairman for holding this hearing to review the issues surrounding the Eurex application that is currently under CFTC consideration.

The Commodity Futures Modernization Act of 2000 significantly altered the regulatory framework for U.S. futures markets. One of the primary goals of the CFMA was to provide an efficient and effective regulatory structure that combines necessary Government oversight and aggressive private industry self-regulation. It is now the charge of the Commodity Futures Trading Commission to provide effective oversight and allow markets to serve the vital economic functions of providing a means for offsetting price risk and providing a mechanism for price discovery. This requires the CFTC to make certain that potential exchanges meet standards that allow for fair and open competition. Competition within our markets is necessary to promote better products and more efficient operations.

The question before us today is not whether or not allowing Eurex to establish a U.S. exchange would increase the competition in the U.S. futures industry, but rather to make certain that this is done in a fair and open manner. The CFTC will work hard on this application and their decision to take the application off the 60-day fast track approval process in order to more thoroughly evaluate the application is appropriate. It would be far better to address some of the complicated and unique issues presented by this application up front as opposed to trying to backtrack and deal with them later. As a committee, I believe it is our responsibility to make sure that the CFTC has the statutory authority and exercises that authority to thoroughly handle the complex issues involved in a foreign owned entity seeking to become a designated futures exchange in the United States.

Mr. MORAN. We will turn to our first witness, which I welcome, my friend and the chairman of the CFTC, Mr. Jim Newsome.

Chairman Newsome, you may proceed.

STATEMENT OF JAMES E. NEWSOME, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC

Mr. NEWSOME. Thank you very much, Mr. Chairman.

Mr. Chairman, members of the committee, I appreciate the opportunity to testify before you today on behalf of the Commission regarding the application filed by U.S. Futures Exchange to become a designated contract market, which is more commonly referred to as a futures exchange.

As you know, through the Commodity Futures Modernization Act of 2000, this committee and then the full Congress profoundly altered the manner in which derivatives markets are regulated in the United States by replacing the one-size-fits-all prescriptive rules of the past with broad core principles aimed at promoting responsible innovation and fair competition among exchanges and other market participants. A portion of the flexibility provided by the CFMA allows for the self-certification of certain contracts and rules. This provision was widely supported by industry, including many of those represented here today.

This is an exciting time for the futures business. Due to a number of factors, the industry that we regulate has grown significantly over the past few years. We believe that a primary contributing factor is the modernized regulatory structure established by Congress through the Commodity Futures Modernization Act. This new flexible approach to regulation has encouraged innovation in the use of cutting-edge technology and has allowed market participants to implement business plans with much greater ease. It has also resulted in an unprecedented number of new entrants into the marketplace.

One thing that the CFMA did not do, however, was limit the Commission's oversight. We continue to have the authority to review and deny, if needed, any rule or contract that we believe falls short of the Act's core principles, whether it is self-certified or not.

Since December of 2000 when the CFMA was signed into law, the CFTC has designated four new exchanges as contract markets and has received three additional applications, including the application filed by U.S. Futures Exchange. Throughout this time, the Commission has been committed to providing a level regulatory playing field for all existing and potential market participants, while being vigilant in its mission to foster markets free of fraud and manipulation, and it is evaluating U.S. Futures Exchange's application accordingly.

To become a designated contract market, an applicant must demonstrate to the Commission that it will comply with the conditions set forth in the Act, which consist of eight designation criteria and 18 core principles. It must also provide sufficient assurance that it will continue to comply with those conditions. If these criteria are not met to the satisfaction of the Commission, designation simply will not be granted.

By statute, the Commission must approve or deny an application for designation within 180 days of its submission, unless the application is materially complete, in which case the 180-day period may be stayed.

By regulation, an application may be considered under a 60-day procedure in appropriate circumstances. Although originally slated for 60-day review, the Commission decided to remove the application from the expedited procedure. It is now reviewing it under the 180-day statutory time frame to ensure that we have an adequate opportunity to fully consider all the issues.

U.S. Futures Exchange formally applied for designation as a contract market on September 16th, 2003. The application includes all general information required by our rules to be considered complete. I have outlined those requirements in my written testimony, Mr. Chairman.

However, the staff is currently reviewing the application and is not ready to submit it to the Commission for approval. According to the application, all trading on the exchange will be done electronically through a version of the trading system that Eurex Frankfurt has operated in the U.S. since the year 2000 in a joint venture with the Chicago Board of Trade.

The trading system will provide a full audit trail of orders, bids and transactions. Audit trail information will be submitted directly to the National Futures Association, a Commission-registered futures association which will provide certain regulatory services for the exchange, such as conducting surveillance for trade practice violations, market manipulation, price distortions and market congestion.

U.S. Futures Exchange staff in Chicago will conduct real-time monitoring of exchange trading activity. Clearing and settlement services will be provided by The Clearing Corporation, a derivatives clearing organization registered with the Commission based in Chicago.

The Commission has published for public comment all portions of the application except for those containing trade secrets or commercial or financial information subject to confidential treatment under the law. In considering whether to approve the application, the Commission will carefully consider all comments received.

As with all applications for contract market designation, Commission staff is currently reviewing the information submitted by the U.S. Futures Exchange to determine whether the operations described in the supporting technical and regulatory services agreements demonstrate that it meets the eight criteria for designation and the 18 core principles.

In the process of reviewing such submissions, particular questions arise on various aspects of almost any application. This leads to an ongoing dialog between Commission staff and the applicant until all questions have been answered and the staff is satisfied that no outstanding issues remain.

The Commission received answers to these questions from U.S. Futures Exchange just yesterday, and we are currently reviewing them to determine whether the responses are satisfactory or whether we will need to ask additional questions.

There are at least two issues that have been raised in various forums, including questions from this committee that the current application before the Commission does not address: a proposed clearing link with Eurex Clearing, which is the clearing and settlement arm of Eurex Frankfurt; and, two, proposed incentive programs for attracting business to the Exchange. Again, I have addressed in detail both of these issues in the written testimony.

In closing, I would like to emphasize that U.S. Futures Exchange has applied to become a U.S. exchange that will be subject to the CFTC's direct regulatory authority. The Commission takes its responsibilities in reviewing applications for contract market designation seriously and is applying the highest standards of regulatory review to the application made by U.S. Futures Exchange. We pledge to this committee that we will review the application, mindful of all comments received, with an eye toward ensuring all necessary standards are met and that only sound ethical business practices are allowed to exist in the U.S. marketplace.

Mr. Chairman, I appreciate the invitation to appear before this committee today and certainly will be happy to answer any questions that you might have.

[The prepared statement of Mr. Newsome appears at the conclusion of the hearing.]

Mr. MORAN. Mr. Chairman, thank you for your testimony.

I recognize the gentleman from Ohio, Mr. Boehner.

Mr. BOEHNER. I want to thank the chairman and welcome Mr. Newsome and all of our guests today.

As most of you know in this room, I have long championed a free market, free enterprise approach to the policy discussions that we have had in this room; and I strongly supported the CFMA, as I continue to support the bill and the work of the Commission.

The purpose of this hearing today is not to undermine the tenets of CFMA or to begin, I don't believe, backtracking on their promises made under that landmark legislation, but the fact is that as we have more competition here in the U.S. we want to make sure

that we have an apples-to-apples comparison, and I do have several questions.

Although EurexEurope is an electronic exchange, as they hope to establish here in our country, it is my understanding that really only a small percentage of the European Government bond options trade electronically. In fact, in the first 9 months of 2003, only 10 percent of these bond options traded electronically. The other 90 percent of the options traded as block transactions, either in the call-around market or through internalization of orders by brokers in which the broker takes the position opposite of his customer. Consequently, there is no centralized price discovery mechanism, and I think the result can often be a fragmented market that is not as transparent as what we see here.

So, Mr. Chairman, I guess the question is, has the CFTC examined the possibility of this type of trading system taking root here in the United States?

Mr. NEWSOME. Thank you, Mr. Chairman.

Both of those things—and you mentioned two, block trading and then the call-around activity—and I will try to address those separately. Certainly with respect to the regulatory system of the futures industry, the regulatory system, we are all in favor of having markets that are as open and as transparent as we can absolutely operate them.

With regard to block trading, that is an issue that the Commission discussed in great detail several years ago, and I have to admit to you that initially upon my tenure at the Commission I was opposed to block trading rules, because I thought it was most beneficial for all trades to take place in a very transparent marketplace.

However, as the discussion progressed and with competition from the over-the-counter marketplace, it became apparent to me that block trading and rules allowed by the Commission to allow block trading offered the exchanges an opportunity to compete in the over-the-counter marketplace or against the over-the-counter marketplace. Because, obviously, if you have got a large block of trades and you try to do those on the floor in what could be an illiquid market, even if it is not, you could get taken advantage of from both a price and a time standpoint; and being able to offer that as a block away from the pit allowed, under the rules that we approved, a fair price for that large block. So, ultimately, I ended up approving block trading rules because I did think it offered an avenue to compete against the over-the-counter marketplace.

I would say that nine exchanges here in the U.S. currently have block trading rules on their books. From a volume standpoint, the percentage of block trading in the U.S., even though they are allowed to do so and have rules to that effect, are much smaller than many of the exchanges in Europe.

With respect to the call-around market, that is a concept that is relatively new to me. In fact, I have just heard that terminology over the last couple days. I am going to give an analogy that compares what I understand the call-around market to be to something that we have allowed, that the CFMA allowed in the U.S., and that is the clearing of over-the-counter contracts. As I have reviewed what the call-around market is, it appears to me that, at the very

least, it is similar to what the CFMA allowed, which was a visionary approach in the CFMA that would allow in some circumstances a designated clearing organization the opportunity to clear over-the-counter contracts.

Since the CFMA was passed, we have allowed I think at least two exchanges the opportunity to clear such contracts, and I think the majority of those are being cleared by the NYMEX Clearing House.

So that is something that we are going to dig into more to find out if that analogy that I just gave you is in fact accurate, but to the best of my ability right now, it would be at least similar.

Mr. BOEHNER. Mr. Chairman I see those red lights flashing. I have some additional questions, and I am sure you wouldn't mind if I submitted those questions in writing to you.

Mr. NEWSOME. Absolutely.

Mr. BOEHNER. Thank you.

Mr. MORAN. The gentleman from Minnesota, Mr. Peterson.

Mr. PETERSON. Thank you, Mr. Chairman.

Mr. Newsome, thank you for being here, and we had a good discussion yesterday. To just summarize the discussion I had with you yesterday, as I understand what is going on here, that if at the end of this process if you prove this, this exchange is going to have to comply with everything, all the laws that the exchanges here in the United States comply with. Is that correct?

Mr. NEWSOME. Yes, sir, that is correct.

Mr. PETERSON. On this issue of surveillance that apparently is going to be going on in Eurex Frankfurt, there is a question, that if they are going to use that for surveillance, how does that work if that exchange is not approved as a self-regulatory organization under the Commodity Exchange Act? Is that accurate, or if this goes ahead, are you going to approve that as a self-regulatory agency?

Mr. NEWSOME. Well, I think there are a couple aspects of that question. One is delegation of responsibilities, and in order for a contract market to delegate core responsibilities it has to delegate those to a registered entity. However, there is another scenario which involves contractual services; and under a contractual services agreement, which doesn't necessarily mean you are providing an agreement or services for a core principle, you are allowed to delegate those to nonregistered entities.

Now it is my understanding that all of the core functions in terms of meeting the Act will either be supplied by U.S. Futures Exchange itself or to regulated entities such as the National Futures Association or The Clearing Corporation.

It is my understanding that there are contractual services agreement with nonregistered entities to supply some marketing assistance, some backup, data assistance, and that would be allowed under the Commission rules. I mean, it would be very similar to a situation that exists today in which the Board of Trade has a contractual services agreement with Eurex to supply the electronic trading system that they have been using; and as that agreement is terminated, they have entered into another agreement with a nonregistered entity, LIFFE, to supply.

So that is not necessarily a unique scenario, but there is a difference between delegated responsibilities and contractual services.

Mr. PETERSON. So what Eurex Frankfurt is going to be doing would be not a primary, whatever you call it, the terminology?

Mr. NEWSOME. Not a core function. But I would add that we are continuing the look at that. We will make sure that that is the case; and unless we are satisfied, we will not approve the application designation.

Mr. PETERSON. Now, this outsourcing to the national futures agency or whatever it is, it has been questioned by some that the amount that is being talked about here, I guess that $600,000, which is substantially less than is being spent by the Board of Trade, for example, and I guess other exchanges here in the United States, could you comment on that, according to my information, the Board of Trade spends like $19 million, and they are going to outsource this for only $600,000. How does that square?

Mr. NEWSOME. Yes, sir, I will be glad to.

A couple of things. One, I want to comment about the National Futures Association, and then there is another industry group called the Futures Industry Association, both of which you are going to hear from later today.

The Futures Industry Association is the more typical industry organization that develops policy, lobbies on behalf of its membership, which is primarily the firms.

The National Futures Association is not a traditional association that represents its members in a lobbying-type capacity. The National Futures Association was created in 1981 under the umbrella of the Commodity Exchange Act to assist the CFTC in providing regulatory functions. We have relied on the NFA through designation of functions now for over 20 years, such as registering intermediaries, conducting audits of intermediaries, just very numerous functions that we have asked them to provide; and they have done so very, very successfully over this time period.

With regard to the amount of resources that they have and the amount that is going to be spent initially on this oversight activity versus what the Chicago exchanges have spent is not an apples-to-apples comparison. I would state, first of all, that the Chicago Mercantile Exchange and the Chicago Board of Trade both do an outstanding job of monitoring their marketplace; and I would also say that they go above and beyond what is required in the Commodity Futures Modernization Act to do so. But we measure by the legal standard in the CFMA of what is required; and based upon the application that has been sent to us, it appears that the NFA is more than capable of meeting those responsibilities.

Now, again, when you look at the money, the $600,000 versus the $19 million, I think you have to keep in mind that on one hand you have got two exchanges that are trading hundreds and millions of contracts, and on the other hand you have got a start-up exchange that has not traded a single contract yet, and there are escalating clauses built in to their agreement. So as volume increases and the responsibilities of NFA increase, they are paid more and have the ability to bring on more staff. So at least at this point that is a concept that we seem to be comfortable with.

Mr. PETERSON. Thank you.

Thank you, Mr. Chairman.

Mr. MORAN. Thank you, Mr. Peterson.

The gentleman from Oklahoma.

Mr. LUCAS of Oklahoma. Thank you, Mr. Chairman; and thank you, Chairman Newsome. You have done a good job in your written testimony, your comments so far today.

If I could work through a few of these points, and I agree with the logic of moving the application from the 60-day fast track review process over to the 180-day fast track.

It appears to me the way the law is structured, Mr. Chairman, that if CFTC determines along with the applicant that more time is needed, together all of the pertinent information necessary to make a final decision, one way or the other, that that is possible. Is that the way you would interpret it? It is possible to go past this 180-day mark if the applicant and CFTC agree that it is necessary?

Mr. NEWSOME. Well, I would go one step further. I wouldn't even say that the applicant has to agree. If the Commission determines that the application is not complete, it is my belief that the Commission alone could stay that 180-day time period.

Mr. LUCAS of Oklahoma. Good. I would agree with that logic.

Do you believe at the point in time you are at at present, looking at your staff resources and the way the process has gone, the information made available to you, will it be possible to make a decision within that 180-day time frame from your vantage point at this moment?

Mr. NEWSOME. I think it is difficult to say right now, Congressman. I mean, we have just gotten responses to their questions.

I would say, unless issues are raised that we are not aware of, it is certainly possible that it could be completed within that 180 days, but if, as typical, the answers to these questions will probably raise more questions that we will want to ask. I would say with regard to the time frame, whether it is 180 days or whether it is stayed, we won't designate until we are fully satisfied that they meet the core principles of the Act.

Mr. LUCAS of Oklahoma. Along that line of logic—and I realize CFTC is reviewing the application in the terms that it is presented where the applicant specifically describes what they propose to do. But in the nature of the way the world works, sometimes events, circumstances, potential business plans develop, courses of unexpected consequences take place. Is it possible under the law the way it is currently worded—can I feel confident that CFTC has the ability to prevent in the future any major deviations or events that would occur that would be different, so to speak, than the application process would imply or discuss?

Mr. NEWSOME. Well, Congressman——

Mr. LUCAS of Oklahoma. That is a western Oklahoma question coming from constituents that are sensitive about the phrase "manipulation".

Mr. NEWSOME. I certainly believe that to be the case.

One, through meeting core principles, the contract market has the responsibility to not list contracts that may be susceptible to manipulation. It is our responsibility as the oversight agency to try and make sure that that is the case, and we do that to the best of our ability.

However, if any time we become suspicious or concerned that a contract, even though it might have been self-certified because of changes in the marketplace or other things outside our control, if we become concerned that that contract becomes susceptible to manipulation, we can either require the exchange to make changes to that contract or we can stop in the most extreme cases trading of the contract. So I believe we have got the authority needed to do so.

Mr. LUCAS of Oklahoma. That is a very important issue. Because while perhaps my average constituents back home don't realize or appreciate just how much influence the institutions that you have oversight over influence everything from their monthly mortgage bill to the price of wheat posted at the local elevator, how critically important—and that leads me to my next question about the issue of self-certification in the way that new contract trading started and that sort of thing. Has CFTC ever stopped an exchange from trading a self-certified contract?

Mr. NEWSOME. Not formally. If you look at kind of how we do things and if an exchange intends to self-certify a contract that they think is either novel or may raise issues, typically they come in and talk to us in advance. If there are issues that we raise, then they work with us to solve those issues before it ever formally becomes self-certified. So because of that up-front process, we have never formally turned down one, but certainly we have had lots of discussions at the front end before contracts have been certified.

Mr. LUCAS of Oklahoma. If the chairman would indulge me for one more question, thinking about Mr. Boehner's observations, the law requires that the Treasury be consulted on certain contracts when Treasury products such as bonds are the basis of the contracts. Has the Treasury been consulted on this application since the U.S. Futures Exchange plans to trade bond futures?

Mr. NEWSOME. The short answer is yes. I personally have had conversations with officials at both the Fed and the Treasury with regard to this, and upon receipt of those contracts yesterday they were forwarded to the Fed and Treasury for their review.

Mr. LUCAS of Oklahoma. Thank you, Mr. Chairman.

Mr. MORAN. Yes, sir. Mr. Lucas, thank you.

The gentleman from California, Mr. Dooley.

Mr. DOOLEY. Thank you, Mr. Chairman.

I will preface my questions with, I am a little bit skeptical about the motivation for this hearing, and the reason for that. I think if the Chicago Board of Trade or the Chicago Mercantile Exchange had submitted a similar application, we wouldn't be having this hearing. I think that we ought to consider, that this is really an issue in terms that there has in fact been a breakdown in terms of the responsibility of what CFTC has done, which to date there is absolutely no evidence that Chairman Newsome and his team are not doing their job in terms of evaluating the Eurex proposal. I think there are some legitimate questions that are being brought up here, but I think we ought to understand that when we passed the reforms our approach here and idea was to give a better environment for the creation of innovation in new products and ensure that we are having fair competition.

I am a little concerned on whether or not what we are doing here is in some ways stifling what could be a—new products are being offered that are going to give consumers and people who are participating in that something of greater value, which I think is good. Because everything we are hearing about now, no one is really giving any attention to the people that would be using the products that Eurex is offering. We are looking in terms of the only approach to ensure that those consumers are being protected is the CFTC, when Eurex is going to have to demonstrate that they are providing something of value.

I am a little bit troubled, and even in some of the testimony that I have read from—even from the Chicago Board of Trade where they give some of their concerns that lead up to the foundation for not even their factual problems with the Eurex application, but they go through four points.

First, Eurex would have you believe that its new exchange would bring electronic trading to the United States. They say that is untrue. I mean, I think it is irrelevant. I think it is irrelevant to what Chairman Newsome is considering.

It says, second, Eurex claims that CBOT is a monopoly. It is not true. I think it is irrelevant to ask whether or not CBOT is a monopoly, certainly in the context of what Eurex is doing.

Third, they go on to say that Eurex would have you believe that it will become the low-cost provider of trading services in the United States. They say that is not true. I think that is irrelevant. If they can offer a product that is demonstrated to have some value to people and value to consumers, then we allow them to go forward.

Then they say, fine, the Eurex would have you believe that it will offer a fully electronic marketplace, and that is more ruse than reality. Why should we care? I mean, we set up a regulatory system to allow for products to be offered under the oversight and the regulatory approach of the CFTC, and we ought to allow that to move forward.

I guess one of the specific issues that I would like to address is there has been some criticism whether or not the incentive plans that Eurex would be offering, whether or not they have offered those for consideration; and Chairman Newsome, I would like you to address that point.

Also, if CBOT or another player on the exchanges were offering incentive plans, do they have to have those approved if they have a modification in those in order to attract businesses or new business?

Mr. NEWSOME. Thank you, Congressman.

Certainly the incentive programs have been something that have widely been discussed in the media and at meetings. I am glad to hear you use the word "incentive," because typically "payment for order flow" is the term that has been used. In a nutshell, that is what in the futures industry we have traditionally called incentives, and that is what they are, incentives to encourage trading in volume on your exchange. There are various kinds of incentive programs that are currently used by our domestic exchanges today. Certainly there are incentive programs that are utilized in other jurisdictions and marketplaces around the globe.

The incentive package—and I think there are two issues here. One, those are packages that are allowed to be self-certified. Their incentives have to become rules. Those rules then in turn can be self-certified. However, I think the bottom line is whether it is self-certified or whether it is submitted to the Commission for preapproval, the bottom line is the Commission still has the obligation to review and decide whether or not to accept them. I think, obviously, if we determine that these incentive packages do not meet the core principles or they don't allow the brokers to follow their proper fiduciary responsibilities, then we are not going to allow that to be the case.

I would say, as I mentioned earlier, traditionally if anything is considered controversial or novel, they come to us first to review it, because the last thing they want is to self-certify it and then have us pull it back. It is not only embarrassing but it is costly for them for that to be the case. So that is the incentive for them to come to the CFTC first, regardless of how they move forward.

But, more specifically, if there are changes to those who have initially been self-certified or preapproved, yes, they would have to go back and go through either that self-certification or the preapproval again.

Mr. DOOLEY. Well, thank you very much. I just want you to know that I personally have a great deal of confidence in your approach to the consideration of this application, and hopefully this hearing just doesn't communicate that there is a broad distrust or concern of a lack of oversight on your work.

Mr. NEWSOME. Thank you, Congressman.

Mr. MORAN. The gentleman from Georgia, Mr. Scott, asked for the opportunity to question the witness out of order. The only way I know how to do that, Mr. Scott, is to yield to you. It is now my turn to ask questions, and I would yield you a portion of my time.

Mr. SCOTT. Thank you very much, Mr. Chairman, for your generosity. I appreciate it. I have a conflict happening at the same time, but I did want to ask Chairman Newsome just this line of questioning.

If the Eurex U.S. application included this intention to trade Treasury futures, would the application review process be different? And specifically, would the Treasury Department involvement be required? Can Eurex U.S. avoid the Treasury Department involvement by not specifying these contract terms?

Mr. NEWSOME. Yes, sir, it is different in this context for the very reason that you bring up. Not only does the Act suggest that Treasury and Fed should have the opportunity to review those, I personally feel that that is the case as well. I have had conversation with officials at both agencies. We have submitted the application and the contracts to them for their review, and we are waiting to hear their response.

Mr. SCOTT. Thank you very much.

Mr. MORAN. Yes, sir. Thank you, Mr. Scott.

The gentleman from Indiana, Mr. Hill.

Mr. HILL. Thank you, Mr. Chairman.

Mr. Chairman, you remarked in your opening testimony that the terminology "call-around" was something that you just learned about in the last couple of days. Could you tell me what you think

call-around means then, since you just learned about it for the last couple days?

Mr. NEWSOME. Throughout this discussion there have been some terms that have been utilized that are not what I would say called traditional futures terms, like payment for order flow, which is typically more of a securities industries term, versus incentives that we have used in the futures business. I think call-around is one of those terms, and it seems to me that it is more of a term that is used in foreign jurisdictions versus in our U.S. jurisdiction, and, because of that, it was a term that I was not familiar with.

As best as I understand and as I have looked into it over the last couple of days, it appears to be similar to a scenario that was created and allowed through the CFMA in which over-the-counter contracts that are traded prior to the CFMA were not allowed to be cleared on a designated clearing organization, and the CFMA allowed that to happen. The Commission has developed rules, and we actually have instances where that is the case now, most specifically at the New York Mercantile Exchange clearing over-the-counter energy contracts.

So to my understanding the call-around would be a similar scenario. As we look into it more and if I find out that that is not the case, I will certainly make sure that this committee is made aware of that.

Mr. HILL. OK. Do you foresee any problems with surveillance as it relates to the definition of call-around?

Mr. NEWSOME. No, sir, not at this point. But, again, that is an area we have just received the answers to these questions. We are beginning the review. I would only say that if we are not satisfied with surveillance methods, then we won't allow the designation until we are satisfied.

Mr. HILL. In conversations I have had with several people over the last couple of days, there was a claim that there is a possible illegality of Eurex self regulatory surveillance being conducted by the NFA. How do you respond to that kind of charge?

Mr. NEWSOME. To the best of my knowledge, I would disagree with that. I think it goes back to what I understand to be language in the bylaws of NFA, and certainly NFA's representative will be here in the next panel to discuss that in more detail. But it is my understanding that there is a difference between delegation of responsibilities, which may be against the by laws of NFA, versus contractual services, which is not against their by laws; and I believe that in this application there are contractual services agreements that would be allowed.

The difference between the two, if you are delegated to perform a function, then you fulfill the responsibility of the contract market or of the exchange all the way from monitoring the market to determining the penalties if they are needed. In a contractual services agreement, you have got the responsibility to monitor the market, but then you pass that information to the exchange, and the exchange then fulfills the disciplinary function that they are responsible for. Under either scenario, the exchange is ultimately responsible for what happens, whether it is delegated or contracted out.

Mr. HILL. OK. That is all I have, Mr. Chairman.

Mr. MORAN. Thank you, sir.

Thank you, Mr. Hill.

The gentleman from Minnesota, Mr. Gutknecht.

Mr. GUTKNECHT. Thank you, Mr. Chairman.

I just want to disagree slightly with my friend, Mr. Dooley. I think this is a serious hearing, and I am glad we are having it. Frankly, I think perhaps we should have more hearings.

I think, if I could use an analogy, let me, first of all, say that I don't think that we envision this kind of an application when we reauthorized the CFTC. Maybe I just asked a short question. Mr. Newsome, did you envision this kind of an application?

Mr. NEWSOME. Quite honestly, I don't think anyone envisioned at that time that this could be the scenario, but I think to me that was one of the great things about the CFMA, is that it created this flexibility for both the Commission and market participants. So while I would have to say honestly I don't think anyone envisioned it, I certainly don't think the CFMA prohibits it.

Mr. GUTKNECHT. Let me say, Mr. Chairman, Mr. Newsome and members, I certainly didn't. I do come at this with certain prejudices, and I will use that term intentionally.

First of all, I am an auctioneer, and I believe in markets, but what we are talking about here is a whole different kind of auction that they want to come in and do.

With all due respect to Mr. Dooley, if an auction company wanted to come into my territory and provide free auctions to the 10 largest auctions next year, I would have very strong disagreement with that policy, and I think at some point you have to deal with that idea of rebating commissions. I mean, I think it certainly raises ethical questions as to whether or not we should approve that kind of an application.

Let me give an analogy there. If some large milk importers wanted to come into California or Minnesota and they wanted to provide milk for free for the first year to the 10 largest consumers, we certainly would raise questions.

Let me also state one of the other prejudices I come at this with. I am the cochairman of the Congressional Study Group on Germany, and I certainly have a very special affection for Germany and the German people, but I have to tell you that their view of fair trade is not exactly our view. If you doubt that, just look at how they deal with us on bananas and hush kits and GMO beans and hormone-treated beef and all kinds of other issues. Our view of that is not their view of that.

I think at the end of the day we have to satisfy ourselves and certainly you have to satisfy yourself that you have the authority to deal with entities that may be a long ways away and may be beyond the long arm of the CFTC to deal with. It seems to me we need answers to those kinds of questions before the application is given final approval, not after. Once the horse is out of the barn, all of a sudden none of this will make much difference.

Can you talk a little bit about this whole idea of rebating commissions for the first year to the 10 largest users? Is that ethical? Is that approved by you? And what do you think the long-term implications of that are?

Mr. NEWSOME. If I might, I would like to comment on a couple of the points that you brought up.

First of all, as a cattleman, in my activities with the Mississippi Cattlemen's Association and working with the National Cattlemen's Association, I can assure you I understand how completely frustrating it is to deal with the Europeans on a number of trade issues, and I know that this Congress is dealing with a lot of that as we speak.

In my current role in trying to fulfill my responsibilities to the Commission and to the Commodity Futures Modernization Act and in whether it was foreseen or not, it seems to me that certainly it is not prohibited. So we are trying to view this application as we would any other.

Now there are some novel ideas that it brings up, and you have mentioned several of them, and those ideas are forcing the Commission to really dig deep in our review.

The incentives is one. First of all, it is difficult for me to comment on the incentive package that Eurex may or may not offer, because it hasn't been submitted to us. I know that, apparently in marketing meetings across Chicago and possibly elsewhere, there have been incentive packages talked about. We do not have an incentive package in front of us. We will at some point, either for preapproval or for certification, and we will view that based upon the criteria that we have looked at other incentive packages. If we don't think it is fair, if we don't think it meets the core principles, if we think it leads the brokers down a path of not considering their customers as a priority or that may inhibit their ability to fulfill their fiduciary responsibility, we just won't allow it.

With regard to the German authority, we have had a long-standing relationship with the German authorities. We have a memorandum of understanding with them that we have had for a number of years, and we have had several instances to utilize that memorandum of understanding. All I can say, based upon our past experiences, is that they have been very helpful and they have provided in the past everything that we have requested and everything that we needed.

In addition to that, through IOSCO, we have just signed, and Germany has just become one of the signatories as well, to a much broader international memorandum of understanding that I think is just as effective as the one that we have between them.

So at this point I am comfortable that we have the authority that we need. If a situation arises or if we get to a point where we don't have the authority that we need, I think we have got the ability and the wherewithal to make changes, whether that is stopping trading or removing market participants, to get to a comfortable point.

Mr. GUTKNECHT. Mr. Newsome, my time is expired, but I do hope that you accept the admonishment that we expect you to take your time and get the answers before the application is approved and not after.

Mr. MORAN. The gentleman from North Carolina.

Mr. ETHERIDGE. Thank you, Mr. Chairman.

As CFTC chairman, you are clearly knowledgeable about what someone must do to establish a futures exchange here in the United States. Are you as familiar with overseas markets?

Let me ask you a couple more questions, and I will let you put it all together.

For instance, do you have an idea of how easy it would be and how long it would take for a U.S. exchange to be licensed for business in, say, Germany or Switzerland or some other country? And are our regulatory processes in these areas similar? Finally, can a U.S. exchange be authorized to operate in these countries 6 months after applying for permission to do so?

Mr. NEWSOME. I will be glad to answer those to the best of my ability.

With regard to how welcomed a domestic exchange might be for designation in another country, I think that is impossible to answer, because that hasn't been the case. I mean, nobody has applied. We have no history to draw from.

I don't question that there is probably more difficulty in getting into other jurisdictions than there may be in the United States, I think particularly since the passage of the CFMA. So generally I would say it is probably easier to access our markets than elsewhere, but, again, we don't have anything concrete to base that on.

The only thing we have concrete with regard to the German markets is that the Chicago Board of Trade, the Chicago Mercantile Exchange, and NYMEX, all applied for the ability to place terminals within the German jurisdiction; and that request was granted. They currently have terminals operating there giving German citizens access to their marketplace. So, as far as I am aware, that is the only concrete evidence that we have that they are at least receptive to those cross-jurisdictional issues.

Mr. ETHERIDGE. But terminal is entirely different than opening an——

Mr. NEWSOME. Absolutely.

Mr. ETHERIDGE. OK. Thank you.

Second, I know that the American exchanges are very concerned about the fair trade aspects of this application. I think we are all aware of that. In other words, competitors having a level playing field and the same line of access to other nations. Does the notion of fair trade have any consideration under CFTC's review of the DCM application sponsored by foreign entities?

Finally, if such reciprocity is not reflected in the CFTC's DCM criteria, should we amend the CEA to make it a consideration?

Mr. NEWSOME. To my knowledge, reciprocity is not included in the CFMA; and because of that, we are not regarding that as an important part or a part, period, of our review. I certainly understand, particularly given my background, that that is a very emotional issue, but it is not currently a part of our consideration; and whether or not the Act needs to be reviewed with regard to that, certainly that is much more up to this body than it is to me.

My only concern is that it could create difficulties with regard to current trade agreements that we operate under. I know based on several things that we have done at the Commission we have been aware of the GATT agreement at times to try and make sure that

we didn't violate that agreement, but, beyond that, I wouldn't have much more to offer, Congressman.

Mr. ETHERIDGE. Let me raise one other point, because my time is running out.

The problem of Enron and long-term capital markets and Arthur Andersen and other corporate problems over the last 3 years are largely responsible for much, I think, of the American public's lack of confidence and trust in the way corporations and companies are governed and, at the same time, in the Government agency's ability to watch over them.

Now I believe we don't have—and let me say that we don't have an Enron problem in this industry, but here is my question: What kind of message is the American public going to hear about trust when someone can submit a DCM application that outlines one business plan but publicly promotes a very different plan and the CFTC can then call them on it?

Mr. NEWSOME. Well, I think the bottom line is that they will not be designated by the CFTC as a contract market to list contracts until we are comfortable with that board. It is my understanding that, as part of the questions that were submitted yesterday, that there is much more detail in terms of how that board is going to be structured. I haven't had the opportunity to look at that, so I don't know, but I would say that board structure and corporate governance we consider a very important issue.

In fact, in May of this year I announced and we have since started a review of our self-regulatory organizations, and review of corporate governance is a part of that review that we are currently undergoing with our existing markets. Certainly somebody that is coming in for an application we are going to hold to that same standard.

There have been accusations across this industry that some of the boards and corporate governance structures are not acceptable. I don't know whether that is the case or not, but I do know that we are reviewing it, and if we find that not to be the case, we are going to make changes.

Mr. ETHERIDGE. Thank you, Mr. Chairman. I know my time is expired, but trust and confidence are a critical part of this whole thing. That is why it makes our systems work well, and I hope you will keep that in mind.

Mr. MORAN. Thank you, Mr. Etheridge.

The gentleman from Georgia, Mr. Burns.

Mr. BURNS. Thank you, Mr. Chairman, and I appreciate Mr. Newsome's input.

I want to follow up on some discussions Mr. Etheridge brought up at the end.

My question deals with the U.S. Futures Exchange. In your testimony, it is a Delaware limited liability corporation. It is a wholly owned subsidiary of U.S. Exchange Holdings that is a wholly-owned subsidiary of Eurex Frankfurt, it is a wholly-owned subsidiary of Eurex Zurich, which is owned in equal parts by Deutsche Borse and SWX Swiss Exchange.

Now, that is a bit confusing, and it is a bit confusing considering the fact that we know who the shareholders are in the Chicago Board of Trade, and we know who the shareholders are in the Mer-

cantile Exchange, and yet there is a board of directors, U.S. Futures Exchange is governed by the board of directors elected each year at an annual meeting each year by shareholders.

My question is who are the shareholders, who elects the board, and what role will they play?

Mr. NEWSOME. I would say that those are questions that we are currently asking.

Mr. BURNS. Those are tough questions.

Mr. NEWSOME. They are tough questions, but in a response from Chairman Greenspan to a request for information, he brought out the point that it becomes more and more difficult to tell who the shareholders are; knowing, now that Chicago Mercantile Exchange has gone public.

Mr. BURNS. But we know who the shareholders are.

Mr. NEWSOME. Exactly, and we are trying to find out who they are in this application as well.

Mr. BURNS. It is a very critical point.

Mr. NEWSOME. Well, ultimately, we know that Deutsche Borse and the Swiss Exchange are in the bottom of that chain that you just went through.

We do know that over 50 percent of the shareholders of Deutsche Borse are U.K. And U.S.-based. For example, two different arms of Fidelity are 10 percent owners in Deutsche Borse, but I understand your question. We are working to get to the bottom of that. I do not have the answer to that.

Mr. BURNS. I think that that issue must be resolved before we can proceed. Another point, and again, Mr. Gutknecht and Mr. Etheridge alluded to this, we are looking for fair and open markets.

I am certainly an individual that would support that. We welcome all competition, the United States. I am concerned that reciprocity is not being addressed here, certainly not in the statute, maybe it should be, but just a quick question: With the terminal access in the European marketplace, was that done on a national level or was it diluted to where our exchanges had to go on a State-by-State basis?

Mr. NEWSOME. The way the German regulatory system is set up, it is both. You have a national regulator and then once you go through that process, then, you have to go through the State regulator, depending on where you want to be located, so there is no question it is a more burdensome process from that standpoint than it is here.

Mr. BURNS. So that, if a hypothetical exchange chose to do the same type, provide the same type of proposal in the European environment, it would find it much more burdensome to proceed to the same point that maybe the U.S. Futures Exchange would like to be provided here.

Mr. NEWSOME. Well, I cannot say that with any certainty, because, to my knowledge, has not been pressed at the designated contract market level, but I think you could certainly draw that conclusion.

Mr. BURNS. Final point or two on transparency, and really our ability to have confidence that this is a free and open and secure marketplace.

I would like to hear your comments about your evaluation of the current proposal, as relates to self-regulation, self-certification and transparency.

Mr. NEWSOME. Well, I think those are differing issues, and the transparency issue has been one of the most emotional, and it always creates a difficult situation for us to be in the middle of what the public wants to see and what we consider to be confidential information that only we have the opportunity to see.

I mean, there is no doubt that, on behalf of competing exchanges, you would like to see it all. It is our responsibility to decide where the line is drawn, because it is exactly like Ford wanted to see the whole marketing plan for General Motors for the next year. They would love to have that information. The CFMA clearly draws the line in terms of trying to decide what is competitive, the information that deals with financial contracts, and just the things that we should be sensitive about.

What we had tried to do, Congressman, is to follow the same process and the same guidelines that we have used for everyone else, and there is a process for appealing, under FOIA, to try to get more information, and we go through that process regularly. Those decisions are made through our general counsel's office, and we are going through part of that process now. So the only thing I would say is that we are trying to make sure that we are fair and we treat everyone the same, with regard to transparency and what we are putting out to the public.

Mr. BURNS. Let me conclude by thanking the chairman. I have great confidence in the chairman and great confidence in the CFTC and I hope we will continue this discussion as we move forward.

The CHAIRMAN. Thank you, the gentleman from North Carolina, Mr. Ballance.

Mr. BALLANCE. Well, gentlemen, I did not have a question, but I think I have got one now. Under this new Act, which I am not very familiar with, I take it CFTC has authority to decide whether or not to accept an application.

Mr. NEWSOME. Yes, sir.

Mr. BALLANCE. And, if somebody does not like your decision, where is the Court of Appeals?

Mr. NEWSOME. I do not think there is one.

Mr. BALLANCE. For example, if the applicant is dissatisfied, what rights would the applicant have to ask for a review and if someone in this body is not satisfied with your decision?

Mr. NEWSOME. Well, typically, it is not just a black and white process. We submit this to you and then do you say yea or nay. It is an ongoing process and it typically starts before they even officially turn in the application. So say an application is turned in to the Commission. We would review that application and normally ask an extensive number of questions to get clarification to that. They would provide those and if there were areas that we disagreed then we would tell them that, in our opinion, this section does not meet the core principles or the Act or we have issues and we are not comfortable, so it begins a process where we are back-and-forth to work through the issues that are in front of us.

At the end of the day, we are the ultimate decider of whether it is designated or not and what is included or not, and I cannot re-

member a time when we were unable, with an applicant, to work that out.

Were they happy?

Probably not, but we have to get to a point that we feel we are satisfied that the core principles and rules of the CEA and the CFMA are met, and, ultimately, that is what we try to get.

Mr. MORAN [presiding]. Thank you, Mr. Ballance.

The gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

My primary interest is in the end-user, the people that are depending on these exchanges on a daily basis to enhance their business opportunities, and there is a lot of discussion has been about the incentives or payment for flow.

In the existing exchanges that are in our country today, are you aware of any practice in any of those exchanges where incentives or discounts are given to any of the members that are using those exchanges?

Mr. NEWSOME. First of all, I think that is one of the good things about incentives, because it makes trading more efficient, and you would hope ultimately that that efficiency is passed on to the customer.

I believe that if you look at the exchange level, most of the incentives are offered to those who are doing the actual trading, and then the question becomes: Are those brokers or are those FCM's, in turn, passing that efficiency on to their customers.

As competitive as that side of the business is, my assumption would be yes, but I cannot say that with certainty.

Mr. NEUGEBAUER. But the question was: You believe today that there are incentives being paid or given by the existing exchanges to, say, high-volume customers?

Mr. NEWSOME. Oh, absolutely.

Mr. NEUGEBAUER. So this is not a new concept of incentivizing large customers or trying to attract large customers, saying if you will bring your business over here, we will clear your transactions for *X* number of dollars?

Mr. NEWSOME. No, sir.

There are a number of types of incentives that we see offered from fee holidays, which are basically not charging fees for a certain period, at the beginning of a new contract, or tiered incentives, based upon your volume of trading and what you end up paying, and we see multitudes of those types of incentives.

Mr. NEUGEBAUER. The other thing, and I think the one thing that all of us have watched in the last year or 2, what we thought were very open and transparent and very honest systems. We are finding out that in some of the exchanges or in some of the houses, for example, we just recently found out that the mutual funds, there was a little bit of call around trading going on after those markets were closing.

And I came from the real-estate business, where sometimes there is a procedure that we do not call it call-around, but property is moved, based on making some phone calls, and I would tell you that, in my personal opinion, there is not much transparency in calling around trading, and I think one of the things I would like to hear from you is where could you see a place in the market

where you could not either in open outcry or in electronic trading that you would need to do a call-around trade?

Mr. NEWSOME. Well, I think it raises two issues, and I will address it from what we consider the traditional block trade and into what I understand the call-around to be.

As I commented earlier, when exchanges first started coming to the Commission to ask for approval of rules to block trade, I was opposed to that, because, quite frankly, I called it non-competitive trading, and I happen to think the transparency is a good thing, and I think, throughout the discussion, the compelling argument to me that allowed me to vote in favor of the block trading rules was the opportunity of the exchanges to compete with the over-the-counter marketplace, because, in our block trading rules, the block trade can occur off the floor, but it has to be within a price range that is suitable for that number of trades, and then it has to be announced to the floor within a specific time frame, depending upon the size of the block, so even though the trade occurs off the floor, it is expressed to the marketplace at some point, and, in an over-the-counter trade, that is not the place.

It takes place, we are never aware of it, we do not hear about it, there is nothing transparent about it, so initial transparency, the fact that we find out at least a portion of the ability to use that in competition was an appealing argument for me that I voted for.

In the call-around market, that terminology is somewhat new to me and so I am trying to learn more about it, but from what I have been able to find out, the call-around is very similar to an over-the-counter transaction between two sophisticated parties of which we have no access and it is not transparent, but, because it is between two sophisticated parties, the decision has been made in the past that that is acceptable.

It is a business decision between those two, and then clearly—the ability to clear that either call-around or over-the-counter contract at least brings that portion of it into a regulated system and information is collected so while, maybe not ideal, I think that they tend to serve a specific function, and I think it is a legitimate function .

Mr. NEUGEBAUER. The call-around trade then is cleared through the Exchange and so the terms of that trade then are disclosed at the clearing, at the end of the marketplace?

Mr. NEWSOME. Yes, sir, through the clearinghouse.

Mr. NEUGEBAUER. It is not my understanding and I would be interested to hear testimony.

Mr. NEWSOME. And as I said earlier, that is new to me and I may be wrong.

Mr. NEUGEBAUER. I appreciate the chairman seems to be sensitive to making sure and even your thoughts about over-the-counter trades, I just would say I have that same sensitivity and as you look at that application and as you approve or look at approving that type of trading, I would ask you, on behalf of the people that use those exchanges, to approach that with caution.

Mr. NEWSOME. OK.

Mr. NEUGEBAUER. Thank you, sir.

Mr. MORAN. The gentleman's time has expired.

The gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman.

Mr. Newsome, thank you for your testimony, and I must say I do not know much about your organization, but I have some confidence in it, because you have got a former student of mine, Marcia Blase, working for you and she is extremely bright and dedicated, so congratulations on having her working for you and that comforts me somewhat.

I find myself in agreement with Mr. Dooley's comments and Mr. Gutknecht's comments, and yet the two of them seem to be disagreeing with one another.

On the one hand, we are certainly interested in competition that enhances the services and prices that individuals who want to take advantage of the futures market can obtain; on the other hand, we are not particularly interested in bringing into the United States, as some mentioned, the Trojan horse, that possibility, Charlie Stenholm, a Trojan horse that could somehow undermine the system that we have in place at present with competition that may not be fair, competition that we cannot even anticipate, that might be difficult, and as I sat here listening, I was comforted somewhat by the thought that the process that you go through, in trying to decide whether or not to approve the application, is one that is very open, and then I went, well, I do not know whether it is open or not, and Mr. Burns asked the question just how transparent is this process?

The reason I am comforted with a very transparent process, a very open process, is you have got very competent individuals who know the business cold who are quite interested in avoiding competition from this foreign source that would like to have an opportunity to persuade you that it is not a good idea to approve this application, and if you are completely open in what they say to you and what you say to them so that these third parties that are interested in this have an opportunity to look at all of that, then they will be in a position to encourage you to ask additional questions, raise red flags with regard to responses, and identify problems that you cannot deal with.

Mr. Gutknecht's suggesting that perhaps there are problems you cannot deal with that you are going to have to come back to us or somebody else and say a concern has been raised that we cannot deal with. It is not in our jurisdiction. It is not the sort of thing we consider.

I am a little worried about that. I guess I find myself wondering how would somebody like me who does not have a great deal of expertise in this particular area, how would somebody like me get comfortable with there is a process that is going to permit a reasonable opportunity for those individuals who do have great expertise and interest in questioning this application to thoroughly question it in time for both you and us, if need be, to take action?

Mr. NEWSOME. Thank you, sir.

Well, I would say, first of all, that there are very large portions of the application that have been put out for comment and that we have received and still are receiving comment on, and obviously we will go through those comments with a very fine-toothed comb, and, as usual, I would expect those comments to raise questions that we will need answers to from the applicant.

I think we are also very fortunate on the Commission that we have a very professional and qualified staff who have been through these kinds of reviews numerous times, who, quite frankly, I think do a very good job.

Obviously, the public comment, the comment from other experts, is very valuable to us, but we include all aspects of the Commission in these reviews, not just the market oversight group that has the ultimate responsibility of making the recommendation to the commission, but we include those who are actually surveying markets to protect against manipulation and we include our enforcement division. It is a commission wide effort to look at, raise issues, ask questions before the staff gets to a point of comfort where they are making a recommendation to us.

I think, without question, I have got the complete confidence in this oversight committee, and, if there are any issues that are raised through our review that are concerns that we cannot address through our rules in the current act, I will personally come to this committee to raise those issues and to start a dialogue of how we address them.

Mr. MARSHALL. That sounds fair enough.

Thank you, sir.

Thank you, Mr. Chairman.

Mr. MORAN. Thank you.

The gentleman from Michigan, Mr. Smith.

Mr. SMITH. Thank you, chairman.

Chairman Newsome, thank you for all your work and for being here.

Mr. NEWSOME. Yes, sir.

Mr. SMITH. What was the key reason that you took the application off of fast track? Was it a lack of information or was it that it looked like the application might not meet the core principles?

Mr. NEWSOME. Let me say, and I appreciate you asking that question, because I haven't gotten that, and it gives me the opportunity to give a real quick background, if that is OK with you.

The statutory language is 180 days. Says nothing about 60 days.

The Commission rule, in trying to further the intent of the Act said there are some rules, possibly some contracts, that we do not need 180 days on, so we developed the 60-day fast track, and I can say from many rule submissions and rule amendments, that process works very well.

From the contract designation standpoint of which we had designated 4, none have been designated within that 60-day period, so I think we need to go back and review whether or not we want to continue to offer that 60-day fast track——

Mr. SMITH. I am hearing you say it is pretty much automatic. If there is any question then you take it off of——

Mr. NEWSOME. Well, I hate to think it is automatic, because we make an attempt to look at things and review things as quickly as possible.

Within a contract market designation, particularly with one as large and as extensive as Eurex, it is just very difficult to get to a point where we are comfortable within that time frame and for that reason we took it off.

Mr. SMITH. The CFMA took away some of your oversight authority. Does CFTC have adequate statute authority to thoroughly evaluate such applications to adequately know the consequences of an approval?

Mr. NEWSOME. Well, I think when an application comes in, it comes in for designation as a contract market. The contracts themselves do not have to be included as part of that application, but, however, they are not allowed to trade contracts until after they have become designated.

Now, as part of that, obviously, they can self-certify those contracts and some of their rules.

While we have given up that up-front or that prior approval, I do not believe we have given up any of our responsibility, because we could always after the fact, if we do not feel that it meets the core principles of the Act, we can pull it.

Mr. SMITH. But you do have, as far as you are concerned, you do have all the statutory authority you need to dig in to thoroughly evaluate, discover, or lock in the clearing procedures that your recollection is suggesting?

Mr. NEWSOME. Yes, sir.

Mr. SMITH. Let me ask you the question of what would be the consequences of an approved application. Do we look at that? Is there a possibility it might put some of our current exchanges out of business? Would it bring down the price to the customers? Does CFTC look at the consequences of an approval?

Mr. NEWSOME. Not from the standpoint of who may win or lose at the end of the competition.

Certainly, I am a strong believer in competition. I think that the CFMA created a very competitive playing field, without regard to open outcry or electronic trading, and it is our responsibility, as the regulator and overseer, to make sure that, if you are going to have competitive markets, you have got to have level playing fields for them to be truly competitive. That is our responsibility, we take it very seriously, and that is the way we approach the review of the contract, this one or any other.

Mr. SMITH. Eurex has said, it's been the least quoted as saying that they might look to a foreign clearing link in the future, but am I correct that this isn't in the application, or is somehow it is locked in that they are going to use the same clearing that we use for the rest of the U.S. exchanges?

Mr. NEWSOME. The application that is in front of us includes a very traditional exchange clearinghouse link.

Now, I understand that, in some of these marketing meetings, there has been discussion about a clearing link with yourself. I would say this: Before trades traded on a contract market in the U.S. could be cleared at a non-domestic exchange, we would require that that non-domestic clearinghouse come in and register as a designated clearing organization.

Mr. SMITH. Do I understand that you do not know through the application process or down by hearings or interviews exactly what products this U.S. Eurex is going to offer?

Mr. NEWSOME. I think we received contracts yesterday. We received the U.S. Treasury complex yesterday, so that is the only

thing that has been sent into us. Beyond that, we do not have those yet.

Mr. SMITH. Mr. Chairman, the red light is blinking.

Mr. MORAN. I had noticed the same thing, Mr. Smith.

Thank you for your attention.

The gentleman from Washington, Mr. Larsen.

Mr. LARSEN. Thank you, Mr. Chairman, and Chairman Newsome, for your thankless job, I want to say thank you to you and your staff, the great work you do.

I want to relate these questions to the criteria that you have to follow. A couple of them prevent market manipulation, fair and equitable treatment, financial integrity of transactions. Those have to do with a fundamental precept of the free market we like to espouse and that is perfect information that really does not exist, but the principle is that most everyone has access to most of the information at relatively the same time, so you can compete fairly and trade information and benefit from that, from that trade so in looking at my colleague's question, my colleague from Georgia's question, Mr. Burns' question, looking at U.S. Futures is structured as subsidiary of a subsidiary of a subsidiary, is there anything in how U.S. Futures is structured that causes problems for you to do your job on the enforcement side?

And let me relate my second question: In your testimony on page 5, you talk about your MOU with BaFin.

The fair and level playing field should not only exist for people to compete, but it should exist for you to have the ability to enforce, as well, so does the MOU with BaFin cover the particular circumstances under which U.S. Futures is organized?

The way it is structured, would you have the ability to do what you need to do to enforce, enforce CFTC rules and regulations?

Mr. NEWSOME. Yes, sir. We feel that we do.

The MOU's are not just a pie in the sky. We have had opportunity in the past to utilize the agreements as part of those MOU's, and we have been successful in doing so.

Will that continue from here out? It is impossible to say, but we have to get to a point where we are confident that that is the case and that we can, in fact, reach those who need to be reached.

There is one scenario that some have called a loophole; I do not know whether it is a loophole or not, but it is a loop hole that exists for everyone, and that is a controlling person who is in a foreign jurisdiction, and if they take non-public information and trade on that information, could we reach them, and the answer is it may be very difficult to do so, but that exists in the structure of our domestic exchanges today, as well as it will exist on the Eurex structure, and the only way that I know to be sure that that will not happen is to not allow foreign participation in our markets, and I do not think that is a viable option, so that is somewhat of an issue. It has never been something that we have had to deal with, but we understand that could be the case, and we are aware of it.

Mr. LARSEN. OK. All right.

Second set of questions has to do with you addressed it a little bit, about the Freedom of Information Act and what information you can release, the judgment that you have to make about what

you should release and what you shouldn't release because of proprietary information.

Do you expect there will be any additional portions of the U.S. Futures application released publicly for further comment or are you at the end of the line in that regard?

Mr. NEWSOME. Well, no. I envision that there could be more released, because it depends upon the answers to the questions that we have just gotten.

If those answers raise material issues in portions of the application that we can make public, well, so, I would say typically that is the case, and my expectation is that there will be more made available for comment.

Mr. LARSEN. Sure.

Thank you, Mr. Chairman. Mr. Chairman, I would like to yield back about 10 seconds of my time.

Mr. MORAN. I am very grateful for your contribution.

The gentleman from California.

Mr. OSE. Thank you, Mr. Chairman.

Mr. Newsome, the regulatory regimes that CFTC operates under, are they similar to, say, the regulatory regimes that the SEC applies to securities exchange?

Mr. NEWSOME. They are similar in a very general nature, but because of the differences in the market places, the differences in the products traded, there are some real underlying differences as well, such as fungibility. Fungibility in the securities market, that is not the case here, so I would say, generally, yes, while there are lots of specific differences.

Mr. OSE. So within those four existing contract designated market places, because of the manner in which the underlying contracts are traded in those markets might vary, there is slightly different means of interpreting the regulatory regime?

Mr. NEWSOME. Well, I think the regulatory regime between the two agencies is quite different and over the last 20 years, the two agencies have taken differing approaches to their regulatory regimes.

Mr. OSE. Well, I want to be clear. I am probably favorably disposed to anything that would create an ability to increase liquidity in these market places, given that we might have some sort of catastrophe in the future.

I will tell you, having served over on financial services, as Mr. Lucas does, as Mr. Baca does, and Mr. Hill, a lot of the things that you are talking about within the market places that you regulate, self-certification, payment for overflow and the like, have arisen in the securities side, and we are having nothing but trouble; in fact, just as an aside, there is a hearing I am missing, right now, over in Financial Services, having to do with mutual fund regulation, and I am trying to figure out why CFTC would not require the same level of disclosure, same principles, same transparency for protection of the investor as, say, the SEC would.

Mr. NEWSOME. Well, a lot of these things have taken place over history and which I was not involved in and am not aware of.

The only thing that I guess I could say is that, even though different approaches have been taken, the results have been good. I think a lot of it goes back to differing market places and particu-

larly differing contracts. Stock on IBM is stock on IBM and within futures markets, you develop a specific contract, and that is your contract to trade.

Obviously, someone can mirror it, but for that reason, we haven't had fungibility, and for that reason, payment for order flow has not been an issue here, where you have got fungible contracts, and there is incentive to try to pull one away from the other, as has been the issues raised in the securities side. So I mean, I think it is, while the general oversight may be the same.

I think, as you look under the surface, it is an apples-and-oranges comparison.

Mr. OSE. The reason I am bringing it up is that we have struggled, since just prior to September 11, trying to get NASDAQ designated as an exchange, and every time one question gets answered, another question arises, and I cannot help but think that this path for Eurex is going to be similarly littered with potholes for whatever reason.

My concern here, Mr. Chairman Moran, is that whatever we do, that we exercise our oversight so that our investors, whether they be domestic and international in nature, know that the front running that might occur elsewhere, or the inappropriate behavior that we are seeing some of elsewhere in other markets is being properly constrained and eliminated at CFTC's markets; I mean, this is a serious issue. I think you talked about trust, or maybe it was Mr. Etheridge; I mean, the same concept holds, and it gets down to balancing our needs for liquidity with our needs for transparency.

My attitude, frankly, is that if you have a public market, you make some nominal adjustments for the different instruments in each market, but the basic regulatory structure should be the same from A to B to C, because then you have a level playing field, and we aren't picking the winners and losers.

I yield back.

Mr. MORAN. I thank the gentleman.

The gentleman from North Dakota.

Mr. POMEROY. I thank the chairman.

I enjoyed my colleague's comments on it and I am inclined to agree with your analysis.

Mr. Chairman, it is good to see you again.

Mr. NEWSOME. Good to see you.

I was almost disappointed when I thought you weren't going to make it.

Mr. POMEROY. No, no.

I've enjoyed your service, think you have done a good job, and also a pleasure to have you here at the Agriculture Committee.

First of all, my thoughts on fast track versus non-fast track. Back when we put that in place, I guess I could irreverently refer to it as the Brooks Leeborn Relief Act. We had a backlog that needed to be dealt with and we needed to free our market participants, and so we put together an expedited review process, but I will tell you what was, in my mind, was products, it wasn't though we scrapped all of the other approval time lines.

Mr. NEWSOME. Right.

Mr. POMEROY. But we had an expedited one.

Simple things ought to be done quickly. That was basically my thinking on it.

This isn't simple, so I am glad you did pull it off of fast track because I do not think it was appropriate for fast track, at least when I voted for it.

I used to be a regulator and that kind of hinders me because I look at the world through the tortured prism of a former insurance commissioner, and I know things there may or may not have any relevance to your job, at all, but on this longer time frame, getting to the issue of disclosure that has been discussed a bit, I think it is important and part of the public purpose served by this longer, more thorough review process, to have all of the information in the public domain that can possibly be there, full immediate disclosure of everything that—but for proprietary reason, should not be placed in the public domain, because you got two groups reviewing this application.

Obviously, the talented and deep staff that you command and then competitors will also be fly speck in this thing, and ultimately it will be your judgment, but their own due diligence review is going to be helpful and bring more resources to bear ultimately for the Commissioner's assistance, and so that is the rule of disclosure and I hope you will put it into the public domain anything that can go there.

Mr. NEWSOME. Can I make a quick comment on that?

Mr. POMEROY. Sure.

Mr. NEWSOME. I agree with you completely and certainly everything that we believe we can put out for public comment, without creating proprietary concerns or trade secrets or financial arrangements, we do so. It has become a more difficult process since the passage of the CFMA, and I will tell you: It is something that we deal with on a very constant basis, and the reason for the difficulty is self certification, if we require contracts to be prior approved, they are put out for comment, then, as a competitor, I can say, well, that is a great contract, I will self-certify it and list it in front of the guy who developed it, so we try to be very cognizant of that, in terms of the competitive nature of the scenario and what is proprietary, but we do work very hard on that.

Mr. POMEROY. I just sensed in your answer to Mr. Larsen that there maybe were some materials that maybe could go into the public domain and haven't?

Mr. NEWSOME. Well, it is based on the questions and we just got the answers to our initial round of questions yesterday, we are reviewing those, and if that raises material issues that we can put out, then we will resubmit that out for comment again.

Mr. POMEROY. Good. The other issue is the one that you referenced, that you really do not have a mechanism to respond or deal with, and that is your realm of regulatory control only goes so far when you look at some of these new global intermingled relationships, and those relationships to, if not squarely part of this application, certainly are kind of in the air around this application.

I think that we need to hear more from you about the response. I do note that you acknowledged some of this is inevitable, some of this has to happen, it is a global economy, global markets, global business, and faster than ever with the electronic format, I agree

with that, but I cannot abide by, so there is only so much we can regulate anymore, there is only so much protection we can offer the American interests, as we have global participation in an exchange of this nature.

We got to do better than that. We really, I think, need to bear down on that one and come up with some strategies that do allow us to preserve and protect the public interest and just I am wrapping up, this is an important point: If we have got our regulatory control here but we have got an entity that is basically foreign-owned, foreign placed and dealing with its counterparts abroad, even on material sometimes, it could be, I think, adverse to U.S. currency interests or something like that, we got to have a way of protecting this violation information.

And so I do not know whether it needs to be dealt with as part of this application, but it certainly needs to be in this brave new world part of the planning for the CFTC, and I would like the Commissioner's response.

Thank you, Mr. Chairman. I yield back the balance of my time.

Mr. MORAN. I have heard you wrap-up before, and that is what I was concerned about.

Mr. NEWSOME. If I could make a suggestion, Congressman, Mr. Chairman, without the proper legal background, I am sure that I have done a very poor job this morning of explaining exactly what our enforcement authorities are within this global marketplace, through our MOU's. So with your permission and the chairman's permission, I would love to be able to go back and in much greater detail, provide that information to you and submit it as part of this record.

Mr. POMEROY. Good. Thank you.

It is a nice way of getting out of answering a tough question.

Mr. MORAN. I would recognize the gentleman from Texas.

Before I do so, I think I will lose my gavel. I would like to take just a moment to acknowledge the passing of a Kansan whose funeral is later today, a former CFTC member, Kalo Hineman, and Mr. Hineman was the chairman of the CFTC and he served there from 1981 to 1991, and a very outstanding Kansan and a distinguished constituent of mine, and I express my condolences to his family, but also to the CFTC community upon his passing. And I now would recognize the gentleman from Texas.

Mr. STENHOLM. Thank you, Mr. Chairman.

Welcome, Chairman Newsome.

Mr. NEWSOME. Yes, sir.

Mr. STENHOLM. Exchange governance is a hot topic.

I would like for you and maybe this fits in the same category you just answered Mr. Pomeroy, but, if you can, please describe for the committee your understanding of the governance structure described in the U.S. Eurex application, in terms of its board, its executives, how will U.S. Eurex structure compare to other Government structures at U.S. Futures Exchange?

Mr. NEWSOME. What I will have to do—that was a question that we ask as part of these rounds of questions we got from the initial application.

It is my understanding the response was much more detailed than what we initially had access to. So Congressman, what I

would love to do is go back and look at that in more detail. I think that that would be ever more accurately than I am able to do this morning.

The CHAIRMAN. Mr. Chairman, we apologize for missing what I understand was a very good discussion. We had to manage a very important piece of legislation on the floor, and I understand that the questions have been very thorough and you covered every topic that I raised in my opening statement, and I will look forward to hearing the details, but I want to thank you for your donation of 2 hours of your time, and I think this is reflected very, very well on the CFTC, and we thank you for your leadership, so let me thank you and excuse you and we will move to the next panel.

Mr. NEWSOME. Thank you, Mr. Chairman.

The CHAIRMAN. We now invite our second panel to the table.

Mr. Charles Carey, chairman of the Chicago Board of Trade, Chicago, IL, who is accompanied by Mr. Mark Young, an attorney-at-law with Kirkland & Ellis of Washington, DC; Mr. John Damgard, president of the Futures Industry Association of Washington, DC; Mr. Terrence Duffy, chairman of the Chicago Mercantile Exchange of Chicago, IL, who is accompanied by Mr. Craig Donohue, incoming chief executive officer of the Chicago Mercantile Exchange of Chicago, IL; Mr. Micah Green, president of the Bond Market Association of New York, NY, who is accompanied by Mr. Michael Decker, senior vice president of research and policy Analysis of the Bond Market Association of New York; Mr. Michael McErlean, director of the United States Futures Exchange of Chicago, Il, who is accompanied by Mr. Ed Rosen, an attorney-at-law with Cleary, Gottlieb, Steen and Hamilton of New York; and Mr. Daniel Roth, president and chief executive officer of the National Futures Association of Chicago, Illinois.

Gentlemen, we are pleased to have all of you here today.

We remind you that your complete statement will be made part of the record and ask that you limit your remarks to 5 minutes. We will begin with Mr. Carey.

Welcome

STATEMENT OF CHARLES P. CAREY, CHAIRMAN, CHICAGO BOARD OF TRADE, CHICAGO, IL, ACCOMPANIED BY BERNARD W. DAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CHICAGO BOARD OF TRADE

Mr. CAREY. Thank you, Mr. Chairman and members of the committee.

I am Charlie Carey, chairman of the Chicago Board of Trade. On September 16, Eurex U.S. filed its contract market designation application with the CFTC. U.S. Eurex is a subsidiary of Eurex Frankfurt, an affiliate of Eurex Deutschland, the only futures and options exchange in Germany. The issues raised by this application are profound and far-reaching. This hearing will promote a serious public debate on those issues. We commend you for your leadership in calling this hearing.

I would like to cover a couple things that really go to the trust and confidence of the application. I think they were referred to or addressed by Congressman Dooley, but I would like to correct the record on a number of key points.

First, Eurex would have you believe that its new exchange would bring electronic trading to the United States. That is not true.

Chicago Board of Trade now offers vibrant and liquid electronic trading markets. Today over 80 percent of our volume in the U.S. Treasury complex is electronically traded.

Second, Eurex claims that the Board of Trade is a monopoly. That is not true. Even Eurex's counsel conceded last Friday to the CFTC it is beyond dispute that there is vigorous competition between U.S. exchanges.

Third, Eurex claims that it will offer a fully electronic marketplace. Again, not true.

The written testimony of Mr. Don Wilson, a major trader on Eurex, the Chicago Board of Trade, and the Chicago Mercantile Exchange, dispels this myth.

Eurex does not trade electronically, options but in a call around market. I mention those mischaracterizations because they bear directly on Eurex's credibility, and credibility is the essence of effective self-regulation.

We have three basic points about the Eurex U.S. application. The application should be considered fully and carefully by the CFTC; second, the application should be considered only when it is complete, and right now it is materially incomplete; third, the application should be granted only if it meets the statutes of specific criteria for registration of an exchange. Point 1, the application review process should be thorough. The Eurex application is too important and raises too many novel issues for consideration under any form of quick fix process. Allowing a foreign board of trade to be the owner/operator U.S. exchange is only one of the many challenging issues the U.S. business plan presents. Some of those issues go directly to preventing manipulation, protecting customers, providing financial integrity and promoting market transparency.

We know that the CFTC is as concerned about these public policy goals as we are. Point 2, the CFTC should have the opportunity to consider the real business plan Eurex proposes to adopt. The U.S. Eurex application however is very different from the business plan Eurex has trumpeted for months in their press statements, Web site, and marketing materials. Just like a consumer should not be subject to bait-and-switch tactics, the CFTC should not be asked to approve one model while the applicant is touting a different business plan. The CFTC should consider the application only when it is complete and accurate.

Point 3, the application should be approved only if it meets the high standards for a new high registered exchange. The decision whether to approve a new exchange is among the most significant decisions the Commission is called upon to make, especially since Congress has recognized that effective self-regulation is what allows our markets to serve the national public interest. That decision should be based on the merits of the complete application and the CFTC's informed judgment, whether the application satisfies the statute.

My written testimony provides specific details on the many issues raised by this application. The bottom line is that we believe the information is materially incomplete now and that the Commis-

sion should suspend its process until the application is complete, and here is why.

The Eurex application is significant for how little it reveals and how much it conceals.

What does it reveal?

It reveals that Eurex intends to trade undisclosed futures and options, using the same electronic system and clearing entity that the Chicago Board of Trade uses right now.

It reveals that Eurex will rely in some way on NFA for market surveillance. That is about it.

What does the application conceal?

The list is long. For example, we do not know what resources NFA has or will use to conduct market surveillance for Eurex. We do not know how NFA or Eurex for that matter intends to police the Eurex over-the-counter caller on market options. We do not know what role Eurex Frankfurt and Eurex Deutschland will play in preventing manipulation on Eurex U.S., how they will avoid the acknowledged squeezes they have in their home markets and by what statutory authority they can avoid for a U.S. designated contract market since they were not registered under U.S. law.

We do not know what clearing systems they will use, we do not know how much of the trading will be cleared in Germany, or how much publicized Eurex Clearing Corporation global clearing link would work or how the CFTC would oversee that activity. We do not know much about this link, other than Eurex and The Clearing Corporation promised that the link would be operational on February 1 or shortly thereafter, and that representation was specifically made to those shareholders who voted to approve the U.S. Clearing Corporation reorganization.

We do not know these things because the application does not address these questions. The statute says when an applicant files its application, the Commission shall have 180 days to review it, but that applies only to complete applications.

In our view and on this record of unanswered questions, the U.S. Eurex, application is very much materially incomplete and the CFTC should suspend its review until it receives a complete application.

The CFTC is a fair agency ably led by Chairman Newsome and his fellow commissioners. We know it is dedicated to serving the public entity and the national interest. All we ask is the CFTC make sure they get a complete and accurate picture of the Eurex application, obtain fully informed public comment and then apply the statute and regulations.

The Eurex application ultimately may be approved, fully or conditionally, or denied. That is an issue for another day.

What we are concerned about today is the process and making sure that all of the issues raised, are made fully by the Commission with due deliberation based on a complete record.

Thank you for your time and attention. I would be happy to answer any questions. Thank you.

[The prepared statement of Mr. Carey appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you, Mr. Carey.

Mr. Damgard, we are pleased to have you with us, representing your organization.

STATEMENT OF JOHN M. DAMGARD, PRESIDENT, FUTURES INDUSTRY ASSOCIATION

Mr. DAMGARD. Thank you, Mr. Chairman, and members of the committee.

On behalf of the Futures Industry Association, I want to thank you for the opportunity to appear before you today to discuss the application of the U.S. Futures Exchange, LLC, for designation as a contract market. When Congress amended the Commodity Exchange Act through the Commodity Futures Modernization Act of 2000, an underlying purpose was to promote responsible innovation and fair competition among boards of trade, other markets and market participants. The application of the U.S. Futures Exchange, an indirect subsidiary of Eurex, marks an important step in realizing the vigorous competition among markets that Congress anticipated in the CFMA.

Attached to my statement is a copy of the comment letters that the FIA has filed with the Commission, which I request be made part of the record and my comments today will focus on the two issues that the committee indicated particular interest in.

The designation process: The CFMA signified a radical new approach to the revelation of derivative markets. Prior to the enactment of the CFMA, the prescriptive regulations had unnecessarily delayed the approval of invasive trading procedures.

To replace these regulations, Congress set out a limited number of broad criteria that an applicant would have to meet in order to be approved as an exchange and certain core principles with which the exchange would have to continue to apply in order to maintain its designation.

Consistent with its goal of promoting responsible innovation, Congress further provided that the exchange will have responsible discretion in establishing the manner in which it complies with these principles.

Congress also specifically removed the statutory requirement that effectively required the Commission to publish applications for designation for comment in the Federal Register. This change in the law promised to expedite the review and approval of new exchanges.

More important, it confirmed that the Commission, as the expert agency responsible for the regulation of derivative markets, is best suited to determine whether an applicant meets the statutory criteria and is able to comply with the core principles that Congress established.

Since the enactment of the CFMA, the Commission has designated four new contract markets, OneChicago, NASDAQ Life, Island Futures Exchange, and the CBOE Futures Exchange.

In each instance, the Commission approved the application without requesting comment from the public. In providing a 30-day period for public comment on the U.S. Futures Exchange application, the Commission presumably determined that its review could benefit from receiving the views of the industry.

Nevertheless, we caution that the Commission must take care not to adopt different procedures for certain applicants that may appear to be designed solely to prevent new entrants from establishing their business in a timely manner. Such actions would clearly be contrary to Congressional intent in enacting the CFMA.

We also want to emphasize that the lack of public comment period has not denied the FIA the opportunity to express its views, with respect to the organization, operation, and rules of exchange applicants.

Rather than dealing indirectly through the Commission, however, we now work directly with the relevant exchange or clearing organization, a change in procedure that has proved to be more efficient or more productive; for example, the Security Futures Committee composed of representatives of the FIA member firms and member firms of the Securities Industry Association met often with the staffs of OneChicago LLC and NQLX and provided both with written and oral comments.

Second, FIA has worked with the Chicago Mercantile Exchange and the Chicago Board of Trade to resolve the numerous operational issues that have arisen in connection with the implementation of their common clearing link.

Third, as with OneChicago, and NQLX, representatives and member of FIA firms have held a number of meetings with the staff of the U.S. Futures staff. In particular, we have recommended several changes to their trading procedures which the exchange has agreed to consider.

Finally, we recently formed an ad hoc group to work with the U.S. Futures Exchange and The Clearing Corporation to resolve operational issues as they develop their clearing link.

Self Regulatory Program—which I will just submit for the record in order to stay with my 1-minute time period, and I will move to my conclusion.

We do not know if the U.S. Futures Exchange will succeed, assuming its application is approved. However, we do know that competition invariably improves markets. In fact, in recent months, we have seen reductions in fees and welcome changes in trading rules that we believe have been adopted in anticipation of the U.S. Futures Exchange application. These changes benefit both customers and intermediaries by reducing costs and facilitating the execution of certain transactions.

We support competition across all markets and all products. Our members compete on a product-by-product basis daily. We see no reason why exchanges should not be subject to similar competitive pressures.

We also see no obstacles that would prevent the Chicago Mercantile Exchange and the Chicago Board of Trade, in particular, from taking the fight to the U.S. Futures Exchange. CME and CBT, in the aggregate, account for approximately 85 percent of the U.S. Futures Exchange volume. In achieving this position, they have demonstrated that they are both fierce and able competitors.

As I noted when I began my remarks, an underlying purpose of the CFMA is "to promote responsible innovation and fair competition." provided an applicant meets the criteria specified in the act and the Commission's regulations, an exchange should be des-

ignated as a contract market upon the same terms and conditions—and pursuant to the same procedures—to which all other applicants are subject.

For example, it is worth remembering that when foreign exchanges first applied to the Commission for authority to place their terminals in the United States, many U.S. exchanges, including those represented here today, argued that the foreign exchanges should be required to come to the U.S., apply for designation as contract markets and compete with U.S. exchanges on a level playing field.

Eurex has agreed to meet this challenge, establishing a subsidiary here to compete with other U.S. exchanges on the same terms and conditions, and subject to the same laws and regulations, to which all U.S. exchanges are subject. FIA would be greatly troubled if the world's largest futures exchange or other entrants that are willing and able to comply with U.S. laws and regulations were unfairly denied this opportunity.

Thank you again for this opportunity to appear before you, and I would be pleased to answer any questions.

[The prepared statement of Mr. Damgard appears at teh conclusion of the hearing.]

The CHAIRMAN. Thank you, Mr. Damgard.

Mr. Duffy, welcome. We are pleased to have you with us today.

STATEMENT OF TERRENCE A. DUFFY, CHAIRMAN, CHICAGO MERCANTILE EXCHANGE, ACCOMPANIED BY CRAIG S. DONOHUE, INCOMING CHIEF EXECUTIVE OFFICER, CHICAGO MERCANTILE EXCHANGE

Mr. DUFFY. Thank you. It is a pleasure to be here, and I want to thank Chairman Goodlatte and members of the Agriculture Committee.

As he said, I am Terry Duffy. I am the chairman of the board of the Chicago Mercantile Exchange. I want to thank you, Mr. Chairman, for this hearing, and I think it is interesting that we are starting to hear a few issues that came forward this morning from Eurex, I think only because of this hearing; and I would like to tick off a few of those I was writing down prior to the first panel.

First is the NFA agreement which was supposedly signed last night. Two is, Eurex has a new board. It went from 1 to 12, kind of interesting. Third is filing of the contract specs. Fourth, withdrawal of payment for order flow. All of this happened yesterday and likely only because of this hearing. That should concern us about this process.

With that being said, CME today is the largest futures exchange in the United States and the largest futures clearing organization in the world. We fully comply with the Commodity Exchange Act and all relevant CFTC regulations. We are also the only demutualized and publicly traded financial exchange in the United States. Our organizational structure, our governance standards, our compensation practices, our business model and our market practices are all publicly disclosed.

The CME, along with the Chicago Board of Trade, accounts for approximately 150,000 jobs in the United States. We offer trading

via both our open outcry and our GLOBEX electronic trading platforms.

During my testimony today I want to make it clear that this is not about open outcry versus electronic trading. Today, nearly one-half of all trading on the CME is fully automated, reflecting the extraordinary growth rate of our GLOBEX system. Also the Chicago Board of Trade's Treasury bond futures contracts, which Eurex plans to compete with, are now more than 80 percent electronic.

CME's concerns with the Eurex U.S. application are simple. The application is defective. Eurex's recent application omits any information regarding its planned means and methods of operation in the hopes of appearing to qualify as a plain vanilla exchange, eligible for fast track treatment. Not surprisingly, the application is so devoid of real information, it fails even to specify the contracts that will be traded. We welcome the news that the Commission shares our conviction that the application require much more vigilant review.

Now that the time pressures of the fast track have been removed, we believe that critical examination of the following four aspects of Eurex's proposed plans is in order.

First, the structure of Eurex U.S.: I find it ironic that Eurex U.S. has claimed a connection with its German parents in order to limit the scope of the CFTC review, but it is quick to enlist German Finance Minister Hans Eichel to plead its case with U.S. Treasury Secretary John Snow and the international press. It will be organized as a wholly owned subsidiary of U.S. Exchange Holdings, Inc..

We have gone through this before, but I will say it again. This entity is a wholly owned subsidiary of Eurex Frankfurt, which is a wholly owned subsidiary of Eurex Zurich, which is, in turn, owned in equal parts by Deutsche Borse and the SWX Swiss Exchange. This is a very complicated picture that presents compelling jurisdictional questions when it comes to holding a real party responsible.

Eurex U.S. is effectively a branch office of the German exchange Eurex Frankfurt. All of Eurex's critical clearing, operational and regulatory functions will be outsourced to third parties; one is Eurex's ultimate parent, based in Germany and not subject to the Commodity Exchange Act. Another major outsourced provider, the NFA, lacks sufficient experience, resources and authority to provide such services.

Eurex must demonstrate that it will prevent market manipulations through market surveillance, compliance and enforcement practices and procedures. It must demonstrate that it meets its obligation to ensure fair and equitable trading through the facilities of the contract market and the capacity to detect, investigate and discipline any person who violates the rules. Accordingly, Eurex should be required to offer sound reasons why the various parties to whom it plans to delegate its responsibilities can meet the CFTC's own essential criteria for designation.

Payment for order flow and internalization. The application omits all information with respect to Eurex's actual business. However, Eurex has publicized it has big plans to capture market share. Eurex intends to buy liquidity. It offered to run a $40 mil-

lion survival-of-the-fittest game that rewards fiduciaries who direct their customer trades to the Eurex platform even when U.S. customers might be far better off trading in more liquid, efficient and transparent markets.

Eurex now claims to have withdrawn its offer of payment for order flow. It is obvious they got caught with their hand in the cookie jar when they shouldn't have even been in the kitchen. Here is Eurex with an application on file, actively marketing to its customers, listing the alleged advantages of their Treasury bond futures contracts over the Chicago Board of Trade's products and discussing payment for order flow, and yet none of this has been submitted to or approved by the Commodity Futures Trading Commission.

I would like to read a quick quote from Chairman Donaldson: "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".

Additionally, Eurex will allow firms to cross or take the opposite sides of their own customer orders to an extent never permitted in the U.S. marketplace. Eurex's application fails to explain and justify these plans.

Third is fair competition. Eurex, with the FIA, has been running a publicity campaign alleging that the Chicago exchanges fear competition. Given Eurex's history, this contradicts reality. Eurex pulled out all the stops to prevent the CME from locating a single GLOBEX terminal in its home territory. Our German lawyers advised us in writing that Eurex interfered, delaying for more than a year. I would be happy to release the documentation for the members of this committee, which I have right in front of me.

The CME's track record for responding to competition has been affirmative and consistent. Let me give you two examples. When BrokerTec applied for contract market designation, the CME sent a three-page letter to the CFTC, which noted a defect in one rule; otherwise, we didn't object. When the Canada futures exchange applied, the CME placed no obstacles in its path. Our comments to the CFTC have always been in pursuit of assuring competition on a level playing field.

Fourth, manipulation and compliance. The ownership structure of Eurex U.S. is particularly troublesome in light of financial press reports about Eurex's lack of enforcement of regulations. It is reported that Eurex has been used for several squeezes involving German debt. The most widely reported large-scale squeeze allegedly occurred in March 2001. Deutsche Bank reportedly cornered the cheapest in a delivery note for the BOBL, the midterm contracting—maturing in March 2001. This resulted in a significant gain to Deutsche Bank, but large losses to individual traders with short positions.

Eurex's response was muted. The allegation concerned market manipulation, yet Eurex issued only a private reprimand to Deutsche Bank. It also appears that the German Government took no action against Deutsche Bank nor in favor of the traders who lost money. This resulted in public criticism of Eurex's approach to regulation was inappropriate and wanting.

Squeezes also have allegedly occurred with respect to the Bund and Schatz contracts. Eurex intends to operate an international linkage that will permit trading in the same contract in two jurisdictions with different regulatory requirements. The Commission needs evidence that wash trades and abusive trading practices allegedly permitted in Germany will not impair the fair operation of our regulated U.S. market. Such arrangements present significant potential cross-border bankruptcy and other legal risks, none of which have been clearly delineated for market users and regulators.

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 the key designation criteria.

In conclusion, the Chicago Mercantile Exchange does welcome Eurex. We expect that upon full examination and careful adjustments to its regulatory and compliance systems, it will prove a valuable addition to the lineup of the world's greatest futures exchanges in Chicago. It is clear, however, that the 60-day fast track process was not the correct path. We hope that Eurex will complete its application, and that its business plans will be fairly assessed. Where the integrity, safety and soundness of our financial markets are involved, judicious public policy compels careful and thorough scrutiny, not a rush to judgment.

In the end, the real winners will be our U.S. investors who will be protected by the American standard of a sound regulatory environment.

I thank the chairman.

[The prepared statement of Mr. Duffy appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you, Mr. Duffy.

Mr. Green, welcome.

STATEMENT OF MICAH S. GREEN, PRESIDENT, THE BOND MARKET ASSOCIATION, ACCOMPANIED BY MICHAEL DECKER, SENIOR VICE PRESIDENT, RESEARCH AND POLICY ANALYSIS

Mr. GREEN. Thank you, Mr. Chairman, and members of the committee; thank you for the opportunity to testify today on this important issue. My name is Micah Green, and I am president of The Bond Market Association, which represents firms and banks that underwrite, trade and sell debt securities and, in particular in the case of this issue today, the U.S. Treasury market. And as I look to my right and see our friends at the CBOT and the CME and I look to my left and I see our friends from Eurex, I realize I am aptly placed in the middle because we are the customer. We are the customer of the futures market.

In fact, the financial futures market is critical to an efficient bond market, a point that I will discuss in further detail later. Every day tens of thousands of Treasury futures contracts change hands to help facilitate the $400 billion daily market in Treasury securities.

The Chicago Board of Trade, which lists Treasury contracts, has for many years provided a crucially important service to the mar-

ketplace. The Bond Market Association has a long working relationship with the Board of Trade and the CME on market trading hours and many other issues. In fact, we worked as close working partners on getting the bond markets reopened in an orderly way immediately following the tragedy of 9/11 and, more recently, after the blackout this summer.

The Association does not come here today to take a specific position with respect to the details and merits of Eurex's application to open a U.S.-based futures exchange. However, it is our view that Eurex's application should be given full and fair consideration by the CFTC and evaluated solely on Eurex's ability to satisfy established legal and regulatory requirements. We do not believe an exchange's country of origin should be a factor in determining compliance with local statutes and regulations.

Indeed, one of the principal goals of the Commodities Futures Modernization Act of 2000 was to promote that very competition among exchanges and to recognize the role that technology has played in the evolution of the markets. The approval of new exchanges, regardless of where their owner is based, is certainly consistent with such a goal. Competition helps ensure that issuers of fixed-income securities are able to borrow at the lowest interest rates possible.

The same holds true for competition among exchanges that facilitate trading in financial products. Fair competition leads to greater efficiencies that are realized by market participants in the form of lower costs and lower risks. Financial futures are an integral part of the financial markets that play a sometimes unnoticed, but critically important role in the global economy. Any development that brings users of financial futures greater choice and therefore the potential of better pricing and efficiency will have a positive effect on the overall economy.

I would like to offer a brief example of how this can be so.

Bond dealers access the future markets to hedge and protect the value of their bond inventories from market swings. Those market swings happen continuously throughout the day and the evening. Hedging involves taking a trading position that offsets another position so that when one position falls in value, the other rises to countervail the loss.

Take the example of a dealer who purchases a million dollars in 10-year Treasury notes. If market interest rates should rise after the dealer makes the initial purchase, the face value of the bonds in inventory will fall, and the dealer will realize the loss. To hedge this position, the dealer would lock in the initial price they paid for the notes by purchasing Government bond futures contracts to sell the same amount of securities. This essentially eliminates the risk of loss, while preserving any upside gain.

For such a strategy to work, it is critical the dealer has the ability to easily purchase and sell the futures contracts at fair prices and low costs. The deeper and more liquid the futures market, the easier and more economically dealers can hedge their positions.

But why is the ability of a bond dealer to trade efficiently good for the economy? Very simply, the easier and cheaper it is for dealers to hedge their trading positions using futures, the more liquid is the cash market for the underlying bond or other financial prod-

ucts being hedged. The more liquid a market is, the less risky it is for investors to hold securities in that market. The less risk investors face, the lower return they will demand when initially buying securities from issuers.

Bond issuers, therefore, benefit from a more liquid market, as it generally means investors will demand lower interest rates on the issuer's bonds. Fostering competition among futures exchanges will, in the end, make it less costly for the Federal Government, States and localities, corporations and individual families to borrow.

Again, Mr. Chairman, I would like to stress that Congress intended to promote this very competition among futures exchanges when it passed the CFMA in 2000; and the CFTC, of course, has long recognized that promoting efficient markets is good public policy. We are confident the CFTC will consider Eurex's application as it would any other submission and make its decision based on the merits of the application.

We urge the committee to encourage the CFTC to act expeditiously and fairly in evaluating Eurex's application. I thank you for the opportunity to present our views.

[The prepared statement of Mr. Green appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you, Mr. Green.

Mr. McErlean, welcome

STATEMENT OF MICHAEL McERLEAN, DIRECTOR, U.S. FUTURES EXCHANGE, LLC, ACCOMPANIED BY ED ROSEN, ATTORNEY-AT-LAW, CLEARY GOTTLIEB, STEEN & HAMILTON

Mr. MCERLEAN. Mr. Chairman and members of the committee, thank you for the opportunity to testify today. I am Mike McErlean, president and chief executive of U.S. Futures Exchange LLC. U.S. Futures Exchange is a U.S. company that is 100 percent owned by Eurex Frankfurt AG. That, in turn, is owned by Deutsche Boerse and the Swiss Exchange. Deutsche Boerse is a publicly traded company with 36,000 shareholders. A majority of the shares are owned by U.S. and U.K. institutional investors.

U.S. Futures Exchange filed an application for contract market designation with the CFTC on September 16. Before speaking about our application, I would like to tell you a little bit about myself, because I think my career really reflects the growth of electronic trading in the futures markets.

I was born and raised in the city of Chicago, and after graduating with a business degree at Illinois State University in 1982, I went to work in the bond pits of the Chicago Board of Trade. Over the next 10 years I rose to manager of the CBOT's 30-year bond futures pit, trading for Goldman Sachs. My clients were the biggest players and the biggest contract at the biggest exchange in the world.

In 1992, Goldman Sachs transferred me to Asia, where an interesting development began to gain acceptance in the world of futures trading, trading electronically. Exchanges in the U.S., Europe and Asia began to recognize the advantages of using technology to offer a service that was less expensive to deliver than the traditional business model of open outcry trading. Markets in Hong

Kong, Sydney and Tokyo were among the first in the world to fully embrace the advantages of electronic trading.

In 1996, Goldman asked me to manage how the firm serviced clients on electronic exchanges. In 1997, I moved to London where I experienced first hand the changeover from open outcry trading to electronic trading, as the Paris futures exchange shut its floor, followed closely by the London futures exchange known as LIFFE. I led my firm's transition to electronic trading and successfully used technology to improve efficiencies and execution services for ourselves and for our customers.

My impression from my work at Goldman and from serving on the boards of various exchanges in three different time zones is that electronic trading, by increasing competition and lowering costs, actually causes the markets to grow faster.

I look at my current assignment at Eurex as bringing the benefits of electronic trading to the U.S. markets and being an agent for change, positive change in client service, fees and pricing, transparency and dynamic growth for the markets in the United States. We believe that there is a significant demand for our model, and that U.S. market participants would welcome the opportunity to trade U.S. and European contracts on a designated contract market with our characteristics.

I would like to summarize briefly some of the features of the exchange. We will operate as a U.S. company, based in Chicago, with all operations conducted out of our headquarters now under construction at Sears Tower. The exchange will be staffed by U.S. employees, acquire services from U.S. service providers and be subject in all respects to the same U.S. regulatory oversight by the CFTC that applies to all U.S. futures exchanges.

I assure you we will establish a representative governance structure that will reflect a diverse cross-section of market users. The board of the exchange will be comprised of 12 members, six of whom will represent different market user groups. Access to the exchange will be available to all market participants, not artificially restricted to a limited membership. All investors will have the same rights in executing their trades with no trading or information advantages to a restricted group of insiders.

Investors will be able to trade at a cost significantly lower than the current cost on the major U.S. futures exchanges. I believe that all U.S. investors, not just our customers, will ultimately benefit from lower trading costs as a result of our entry into the U.S. market.

The CFTC has published our application for public comment. This is an important part of the regulatory framework, and I pledge that we will respond promptly to all legitimate concerns that may be raised.

I would like to conclude by saying that our entry into the U.S. market will bring greater competition to the U.S. futures industry, benefiting all investors and the U.S. futures industry itself. This will help to achieve the goals of the Commodity Futures Modernization Act.

I am happy to answer any questions that the members of this committee may have. Thank you.

[The prepared statement of Mr. McErlean appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you, Mr. McErlean.

Mr. Roth, welcome.

STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION

Mr. ROTH. Thank you, Mr. Chairman. My name is Dan Roth, and I am the president of National Futures Association. I very much welcome the opportunity to testify today and to describe for you the types of regulatory services that NFA is prepared to perform for USFE if, in fact, it is designated as a contract market.

By way of background for those of you not familiar with NFA, I should mention that NFA is the industry-wide self-regulatory body for the U.S. futures industry. We do not operate a marketplace. We never have. Our sole function over the last 21 years has been regulation and the protection of customers. We see our basic mission as working in close partnership with the CFTC to provide this industry with the most effective and efficient regulation possible. And I would like to note for you that over the last 21 years, while trading volume on U.S. futures exchanges has increased by over 400 percent, customer complaints during that same time period have dropped by over 70 percent, and we are very proud of that accomplishment, proud to have been part of the regulatory process which produced those results.

Like any organization, like any regulatory body, we know that we have to keep pace with changes that are occurring in the futures industry; and it was in the spring of 1999 that our board of directors first discussed and approved the first of several strategic planning reports. One key initiative in the 1999 report focused on NFA adding value to the industry by offering to perform self-regulatory services and functions on behalf of electronic futures exchanges.

In February 2001, the board again discussed and reviewed our strategic plan and unanimously approved an amendment to our articles of incorporation to provide and make clear that providing regulatory services to markets that the board approves is one of NFA's fundamental purposes. Because there was some question on this point, let me also point out that the articles do provide and have always provided that NFA shall not adopt or enforce or administer any of its rules against any of its members or associates in any way to interfere with the contract market's jurisdiction.

The type of regulatory agreement that we have with Eurex does not in any way involve the application or enforcement or administration of NFA rules against any NFA member, and in fact, we don't even adopt or administer Eurex rules or USFE rules. To the contrary, we provide certain regulatory services, prepare reports and turn those over to USFE for its ultimate determination as to whether disciplinary sanctions are warranted.

To date, our executive committee, acting on behalf of our board, has unanimously approved and authorized staff to execute regulatory service agreements with four different exchanges, all of which have been approved by the CFTC, that is, BrokerTec, Merchants Exchange, Island Futures Exchange and OnExchange. We

currently provide services for two of those exchanges, BrokerTec and Merchants, both of which operate at low-volume levels.

I would note also that our senior management and our board of directors recognized that NFA would need to obtain special expertise to perform the practice and market surveillance functions that were contemplated. Our first step in implementing the board's strategic plan was to hire Yvonne Downs in early 2000. Prior to joining NFA Ms. Downs worked at the Chicago Board of Trade for almost 20 years. In 1995, the Board of Trade promoted her to senior vice president and administrator of the office of investigations and audits. In that position her responsibilities included the supervision of five regulatory divisions including surveillance and investigations.

Under Ms. Downs's direction, we developed our own market surveillance and trade practice program, which we call TAPS, the Trade Analysis and Profiling System. Ms. Downs has also hired a number of individuals with extensive experience at the Board of Trade to help her in that effort; and more importantly, we have a compliance staff of about 100 people.

Over the last 3 years we have cross-trained up to 12 of those individuals in market surveillance and trade practice functions so that they are there if need be, as circumstances warrant, to supply our forces to perform these functions; and obviously we will not hesitate to hire outside of NFA just as we have in the past.

I would also like to point out that with respect to the Eurex or the USFE application, we have tried to treat that like we have any other application, each of the four that I have already alluded to. Each of the four were presented to our executive committee for their approval. The executive committee voted in October to approve this contract by a vote of 7 to 1; and as in every other instance where we have entered into one of these agreements, we have always informed the board at its next meeting. We intend to do that at the November 20 board meeting. As with any decision by our executive committee, the board always has the implicit authority, if it chooses to, to review and possibly reverse that decision.

There is a detailed report or description of our trade practice and market surveillance program, and I will spare you a dramatic reading of that, but I would like to let you know that over the last 21 years we have built a reputation as an effective and efficient regulator, and we have done it in the face of getting additional responsibility over and over from the CFTC. In every instance, we have taken the approach to just do the job right, and we won't hesitate to use that same approach here.

We will devote whatever resources it takes to do the job right; and if we find that the contractual agreement does not provide for us to recover our resources, Mr. McErlean is going to hear about it in a hurry, and he can either renegotiate those fees so that we do recover the cost, or he can find another regulator.

With that, Mr. Chairman, I am over my time, and I would be happy to answer any questions.

[The statement of Mr. Roth appears at the conclusion of the hearing.]

Mr. MORAN [presiding]. Mr. Roth, thank you very much.

Mr. Boehner.

Mr. BOEHNER. Thank you, Mr. Chairman.

Let me welcome all of our witnesses on the panel. And I want to especially welcome Mr. Green, who we haven't seen much of since he became the president.

Sorry to see that your hair is becoming a lot more gray than it was when you ran your Washington office.

I find myself in full agreement, Mr. Green, with your analogy that competition makes all of us better. As I said earlier, I am a big believer in competition. Having grown up with 11 brothers and sisters, you learn to compete rather quickly, and during my years in my own business, you see the benefits that competition brings to the marketplace, as much as I hated having more competitors.

I understand where the Chicago exchanges are coming from, but Mr. McErlean, you have been beaten up here pretty good this morning. I thought I would give you an opportunity to respond to the charges that your application was incomplete. Let me ask this first question that was raised by Mr. Duffy's testimony, when apparently on your application there was listed one board member, and in the submission last night to the questions from the CFTC, we now have 12 board members.

Mr. MCERLEAN. Well, Congressman, we submitted the application in back on September 16 you have to understand we are a start-up company, we are a new organization. There are many things that we would like to do in the future that we haven't necessarily thought out yet or brought to the market, because we are still in consultation with market participants that would benefit from any services that we may offer.

So that is, my answer for going from one director to 12. It was never our intention to start a futures exchange with one director. We will have the same governance structure that is widely accepted here in the United States.

In regard to the incomplete application, I would say the fact that the public does not know everything about the application does not mean it is not complete. Our application is over 2,000 pages that we submited to the CFTC. And we understand the competing exchanges' desire, as a competitor, to know as much as possible about what is inside those applications; however, competitively sensitive information is precisely what the law, and for good reason, protects from disclosure. Other information like regulatory services agreements are not disclosed because disclosure would compromise the market surveillance to be performed under that agreement.

The Commission is perfectly competent to review the entire application, including the competitively sensitive portions that are not made public.

Mr. BOEHNER. Mr. McErlean, you heard the discussion that went on earlier about the call-around practice that is apparently prevalent in Europe, where some 90 percent of the trades ever really go through the exchange and that this practice does not occur here.

Do you expect that this call-around practice will be brought to the States?

Mr. MCERLEAN. I will tell you that U.S. Futures Exchange is committed to developing a liquid and successful screen-based options marketplace. We have made significant technology invest-

ments so that we can provide new functionality in our electronic system that we will be introducing with the rollout of the new exchange. We have things like a strategy builder——

Mr. BOEHNER. So we are not going to have call-around activities in the United States?

Mr. MCERLEAN. I would say that we are committed to a fully electronic market for trading options here in the United States.

Mr. BOEHNER. Let me ask the question about incentives that—at least Chairman Newsome referred to them as incentives—in your marketing materials you committed to refund up to half the fees to the top 10 producers in terms of those who bring volume to your exchange.

Is this in the best interest of the customer or those who bring the business to you?

Mr. MCERLEAN. It is in the best interest of the customer if we create a vibrant, liquid marketplace. We are confident that the people that received our marketing material received it in the manner in which it was intended, as a discussion piece.

Mr. BOEHNER. Do you or do you not intend to offer the 10 largest companies who bring you business an incentive or discount?

Mr. MCERLEAN. We are in discussions with our market participants regarding what would incentivize them to trade on our exchange, but I assure you we will not produce any type of incentive program that is not condoned under CFTC law.

Mr. BOEHNER. Thank you, Mr. Chairman.

Mr. MORAN. Mr. Stenholm.

Mr. STENHOLM. I like the answer to the last question Mr. Boehner asked, because what was being proposed was getting on awfully thin ice for someone that was purporting to be interested in setting markets and trading customers in a fair way. I think your answer is a good one, and I think CFTC will be very interested in that.

The primary purpose of the Commodity Futures Modernization Act was to transform the Commodity Futures Trading Commission from a front line regulator into an oversight agency. U.S. futures exchanges sought the opportunity to self-certify rules and contracts for a number of reasons, including having the opportunity to shield new products from competition. The act was designed to give the futures business greater flexibility to offer useful and innovative products.

How does the Eurex U.S. application fit in with the purposes and spirit of the Commodity Exchange Act, as modified by CFMA? Is this application not an example of the type of innovation that was sought from this committee and granted?

Mr. Duffy, Mr. Carey, I think would be appropriate ones; or any of you other than Mr. McErlean.

Mr. CAREY. As I stated in my testimony, we think the application is materially incomplete. They must believe that it was materially incomplete, because they have changed it or they have brought in more information. And we think that this hearing has probably generated that information.

So I think it really will allow the CFTC to do a better job in reviewing these practices that are called into question, and we think

our questions were regarding inadequate information on market surveillance programs.

Again, you cite the call-around market. You cite Don Wilson's testimony, which was presented to the committee in written form, where he cited the fact that there is indeed payment for order flow and there is indeed the ability to internalize flow. And these are practices that could basically be brought into this country unless we we don't have to know, but the CFTC has to know about the electronic systems and their capabilities and how exactly these markets will be conducted in light of the fact that today 90 percent of the volume on the option market is done at a call-around, voice-brokered. And it is merely posted to the electronic match; it is not really traded electronically.

So from that standpoint, these are some of the concerns. Obviously, no terms and conditions of the contracts to be traded have been disclosed. I guess they have changed that in the last 24 hours, if I understand the testimony correctly. And I think that another issue for the CFTC that they will have to deal with is, obviously if they are changing the technology that the Board of Trade has been trading on, and they are going to provide new technology, then I think it probably should have to come under some sort of review process with the CFTC.

So while the modernization act does provide the CFTC with flexibility, they also have the flexibility to require Eurex to file its real business plan in a complete application.

Mr. DUFFY. Mr. Chairman, if I may respond to that also, I think Charlie said it correctly that we have just now received, and Chairman Newsome said he received, these contracts last night. I think that is exactly what happened. This hearing has brought that to the front, and for several reasons. I think that the contracts have been out there.

We talk a lot about these marketing materials, about payment for order flow and things of that nature that the people from Eurex have been promoting, but now they want to decline it and say it was just a discussion document. I don't know how you go to clients and say this was what you were promoting, but now you are not going to follow through with it.

That being the point, when you have contracts—and they have come out right from the beginning, regardless of the Commodity Futures Modernization Act, that they were going to list U.S. debt, U.S. Treasuries cloning the Chicago Board of Trade's contracts. Once that information is made available, they are supposed to submit it to the CFTC. The reason they did not is so they could circumvent the Treasury to the last minute and self-certify. I mean, it is quite obvious why they did what they did.

Mr. DAMGARD. Can I help out Mr. McErlean on this one?

I believe that the answer to this one is a simple yes. My members probably transact somewhere around 90 percent of the business on both of these exchanges, these two great exchanges on either side, who do a fantastic job.

They also have an awful lot of business on Eurex, but Eurex has gone from zero to the largest in the world in 10 years, not because they haven't won the confidence of these traders or these firms. They also have done an excellent job.

And the fact that they are willing to close their market 2 hours early in Frankfurt and open in Chicago to accommodate American traders, and American traders who are now electronically accessing their market subject to German law, that is going to change if and when they are approved. And that means American traders, many of them members of these two exchanges, will be trading in the United States subject to CFTC regulations. Revenues will be coming out of Frankfurt into Chicago; and it seems to me that that is good.

Competition is very healthy, and let the competition begin.

Mr. MCERLEAN. I would like to add that the CFMA does work in that when we put our application in, the CFTC came back to us with questions. We answered those questions. Those generated more questions.

We have come back and answered the questions that they have had. We have not tried to hide anything about what we plan to do in the United States. We want to become a U.S.-regulated exchange under the same oversight that the exchanges at this table are under, and we don't expect any special treatment at all.

So I would just submit that the system works.

Mr. GREEN. Congressman Stenholm, to give the Bond Market Association's perspective, the genius of the CFMA that emanated from this committee is that it didn't create a box in which to regulate. It created a framework that had flexibility to grow and change with the times, and I think the reason we are sitting here is because the times are changing and the CFMA is working.

So I would say the answer, just as Mr. Damgard said, to your question is a resounding yes.

Mr. MCERLEAN. If I may yield the microphone to my colleague.

Mr. ROSEN. Forgive me. I just want to clarify. As Mr. McErlean said, the responses that were given yesterday were not given as a result of the hearing. They were given in response to questions that were provided by the CFTC before a hearing was ever scheduled.

I would like also to respond a little bit to the discussion on internalization in the call-around market, because I think there is some confusion about that and confusion about the roles that exchanges play in it.

I would start by observing that no exchange—no exchange; I will repeat that—no exchange benefits from vibrant off-exchange markets, because off-exchange markets compete with exchange markets. The exchanges don't create these call-around markets.

Eurex in Europe is not thrilled with the notion that most of this business is conducted other than on the exchange, but we must understand this market exists in the United States as well. The only reason the Chicago Board of Trade isn't here talking about what its percentage is in the relationship between those trades in the exchange-traded markets is because it doesn't see that, because it hasn't made the choice that Eurex made that there is an incremental public benefit in allowing those transactions, once they have been executed, to be submitted to a regulated clearing facility to mitigate the credit that is associated with those transactions and to build up the open interest that provides more opportunity for liquidity through the liquidation of trades that are executed on the exchange.

So Eurex is committed—USFE is committed in the United States to having as robust, deep and liquid an exchange-traded market through the screen-based trading system and is not incentivized in any way to promote off-exchange trading.

Mr. STENHOLM. Would you identify yourself for the record, sir.

Mr. ROSEN. Yes. I am Ed Rosen, R-O-S-E-N.

Mr. STENHOLM. Mr. Duffy.

Mr. DUFFY. Mr. Chairman, if I could make one comment on the call-around market, which Mr. Rosen just explained very well; and I am sure he has traded a lot of markets on the call-around, but someone who is very knowledgable about the call-around market is John Gilmore, who is the former head of global futures at Goldman Sachs.

I quote from Mr. Gilmore: "It is a very opaque marketplace that favors only the people that it decides to favor." That is a quote from Goldman Sachs, the former head of global futures, not from me.

The CHAIRMAN [presiding]. I thank the gentleman.

Mr. McErlean, I understand you are the sole administrative officer of Eurex U.S.?

Mr. MCERLEAN. That is correct.

The CHAIRMAN. And who do you report to?

Mr. MCERLEAN. I am the president and CEO, and I am responsible for the operations of U.S. Futures Exchange here in the United States.

The CHAIRMAN. And who do you report to?

Mr. MCERLEAN. I have reporting lines through to Frankfurt if I need help to make a decision. I also speak to my colleagues in Chicago. I also speak to market participants and people I know within the industry.

The CHAIRMAN. And I understand from your testimony and what we heard earlier that you plan to have and may now have a 12-member board of directors. Have you appointed those members?

Mr. MCERLEAN. We have not done so yet.

The CHAIRMAN. All right.

Mr. MCERLEAN. But it will be done before we start operations as an exchange.

The CHAIRMAN. How will that board of directors be selected? Will any of the members be officers or employees of Deutsche Boerse or Swiss Exchange?

Mr. MCERLEAN. Well, we have contemplated and are discussing having U.S. investors invest in the U.S. Futures Exchange, and at least six of them will come from those market investors.

The other six will could be European or foreign ownership, but the majority will be U.S. participants.

The CHAIRMAN. How will those directors be compensated?

Mr. MCERLEAN. I am not aware that there will be a compensation for the directors as yet, as these issues are still being discussed.

The CHAIRMAN. These are not resolved?

Mr. MCERLEAN. Right.

The CHAIRMAN. Well, let me just ask you this. As you know, corporate governance has been a grave concern of the Securities and Exchange Commission and other regulators and the Congress over

the last years. Do you expect to have a working board of directors prior to beginning Eurex U.S. operations?

Mr. MCERLEAN. Yes, we do.

The CHAIRMAN. And should the board be in place prior to the CFTC's approval of your application?

Mr. MCERLEAN. If it is not, when we appoint the board, we will certainly let the CFTC know who the management structure is.

The CHAIRMAN. Mr. Damgard, or Mr. Green for that matter, your testimony indicates your association favors competition among exchanges. As you know, there was some controversy around the vote of the former Board of Trade Clearing Corporation to allow Eurex U.S. to clear trades at the clearinghouse.

Do you have any thoughts about competition among clearinghouses, and do you believe the Commodity Futures Modernization Act envisioned competition among clearinghouses?

Mr. DAMGARD. I think competition is healthy. I think that the model in the futures industry is working rather well. We have had concerns in the past over the governance of the clearinghouses.

We also admire the model in the options industry where there is one central clearinghouse that is run as a utility, where each and every new exchange that is designated by the SEC has access to the same pool of liquidity. It certainly has benefited the investor, but obviously in a competitive environment like that, there are winners and losers.

Some of the start-up exchanges, the all-electronic exchanges, have done extremely well in taking market share away from established exchanges like the Chicago Board Options Exchange, and the result has been that the Chicago Board Options Exchange has been very aggressive in playing catch-up ball. And all of that benefits the investor. That is called fungibility, and we have talked about that in the past.

The fact that the Board of Trade and the Mercantile have combined their clearing operations and reduced the costs of running two clearinghouses, all those trades, 85 percent of them now, all being processed by a very, very fine clearinghouse is something that will save the firms a lot of money.

The issues that we have so far are, since all the money, or virtually all the money, in that clearinghouse is put up by the clearing members, we are concerned that there is not representation on the board of the Mercantile that oversees the decision-making with respect to that clearinghouse. And the fee structure at the clearinghouse is subject to the board of the Mercantile, and the Mercantile, as you know, is now a for-profit entity.

That clearinghouse captures all the trades. There is no way that those trades can go anywhere else, because the Mercantile's rules require those trades to go to that one clearinghouse, and that clearinghouse has really no constraints other than its own board in terms of raising the fees.

The CHAIRMAN. Mr. Green.

Mr. GREEN. Mr. Chairman, I have no crystal ball, so I can't predict exactly what the outcome would be, but my gut tells me philosophically that we would believe that competition would lead to a better marketplace.

In the cash market for Treasury securities, there are two principal clearance banks, Bank of New York and JP Morgan Chase. And in fact the Federal Reserve has looked at whether or not two is enough. We happen to believe that the dynamic of the two creates a kind of competitive environment to ensure sufficient redundancy, to ensure efficiency and use of technology.

But competition is good there. Competition is a good element. So just philosophically, from where we sit, we can only believe that the infusion of competition would be a good thing.

The CHAIRMAN. Mr. Damgard, what business advantage does Eurex gain by establishing a physical presence in this country? Is there some opportunity available to Eurex that it cannot obtain operating its electronic system from Europe?

And is that opportunity more about a clearing and settlement operation than a trade execution operation?

Mr. DAMGARD. That question probably is best put to Eurex. I don't know. I mean, I am welcoming Eurex and any other exchange that wants to come in and compete on a product-by-product basis. I would be here cheering just as loud for the two Chicago exchanges if they were to list Eurex's products.

What this industry needs and has needed for a long time is direct competition on a product-by-product basis. I would love to ask my two pals here, Why haven't you listed the other guy's signature product?

The CHAIRMAN. Well, let's let Mr. McErlean answer the question you didn't answer.

Mr. MCERLEAN. We have screens here in the U.S. already, and we could list the U.S. products on those screens and trade them and clear them in Europe.

But we feel that there is an advantage to starting a U.S.-regulated exchange under the scope of the CFTC and to clear those products here in the United States and give our clients, the end clients, choice of where they, A, want to trade those products and, B, where they want to clear those products.

Our clients have told us that they think it would be advantageous for them to be able to clear some of these products, both European products and the U.S. products, under one regulatory infrastructure in one clearinghouse. It gives them ability to manage their collateral more efficiently. And so we are trying to respond to the market and what the market is asking us for in terms of value-added services.

And we would like to be able to deliver those value-added services to the market. And that is why we have been discussing our clearing link with market participants; and when our clearing link is established, we will be going to the CFTC to get their OK regarding the parameters of that clearing link.

The CHAIRMAN. Let me ask if Mr. Duffy or Mr. Carey want to respond to any of what——

Mr. DUFFY. If I may, I would like to respond to a couple things.

And I think I heard a few things—I don't know if Mr. Damgard is trying to start a debate, but I would love to do it with Mr. Damgard on competition, because the Chicago Mercantile Exchange has had competition since its existence, for 105 years.

I have something in front of me that shows over 100 different examples since 1858 where the Chicago exchanges have had competing product. So I don't know what we get about competition.

We have traveled the world around. The people sitting behind me, Mr. Melamed and Mr. Sandner, have traveled the world around helping foreign exchanges open up their contract markets so that we could compete.

This is not a hearing about competition. If this was strictly a hearing about competition, I would fly to Frankfurt, pack Rudy's bag and help him move over here. That is not the case. This is a case about regulatory framework. That is our concern.

So we have no issues with competition. We welcome the competition. We thrive on it. We have done it for 105 years. We will for another 105 years.

We talk about the extraordinary growth rate that has happened with Eurex. Well, if you look over the last 3 years, the growth rate of the Chicago Mercantile Exchange has exceeded that of Eurex. We have come to the forefront in competition. We are not concerned about it, sir.

So again, I think that this is something that we are concerned about, the regulatory framework issues, the payment for order flow issues, manipulation and things of that nature. It is not about competition.

The CHAIRMAN. Thank you.

Mr. CAREY. I would just echo that. There has been competition on occasion going back, but it seems that liquidity is the measure of cheapest costs, and whoever achieves the liquidity provides the tightest market.

But going back to regulatory framework, we appreciate the ability to be here today and comment, because as we have noted, the story tends to change; and we think that Congress intended the applicant for registration to file at the CFTC the same business plan that it is offering to the public.

The CHAIRMAN. Thank you.

Mr. McErlean.

Mr. MCERLEAN. I guess in terms of electronic trading and the growth of electronic trading here in the United States, it has been dynamic over the last 3 years. In fact, the Chicago Board of Trade open outcry volumes peaked in 1998 and have been going down ever since.

I would like to think that their growth in the last 3 years is because they have been trading on the Eurex trading system since August 2000, and their volumes have gone from 8 million to 52 million to 126 million in a 3-year period.

But what our clients are telling us is they would like us to come to this market and compete, because they know that while we trade electronically and these other exchanges trade electronically also, the fees and pricing structure that we have is a lot more advantageous to the end client.

Now by us coming here, miraculously some of the fees and pricing at the Chicago exchanges are coming down, and I think that is exactly what the CFMA intended when it was passed several years ago. I think the system works, and competition is good.

The CHAIRMAN. Thank you very much.

The gentleman from California, Mr. Dooley.

Mr. DOOLEY. Thank you, Mr. Chairman, and I came back in part to give anyone that wanted to comment on some of my earlier comments a chance to either object or raise questions. But guess I am coming at this from the standpoint that I think, in some ways, Eurex's application is a validation of the Commodities Futures Modernization Act. I thought that is what we had in mind, that we had no idea as policymakers what products would be offered and developed out there. Our challenge was, how do you create a regulatory environment that is going to allow for innovation and creativity, the development of products and can respond to a market demand?

So that is kind of the way I look at this, and I guess on the issue that this is not about competition, when we are talking about a regulatory framework, I think that would have greater merit if there was a clear demonstration that the regulatory framework is broken down.

But the Commodity Futures Trading Commission has not even finished their consideration of the application that has been submitted. You cannot even point to, now that there is cause for us to as policymakers to say that there has been an abrogation of the responsibility that we have endowed in the Commodity Futures Trading Commission.

They have requested additional information from Mr. McErlean's group, and they have responded to that. I have a hard time really understanding is that it looks like this hearing in part is motivated—from my perspective is that there is some real concerns about a competitive model coming in.

Even the comment, Mr. Carey, you made about new technology, I mean, as one member who really has felt very strongly that there was a need for new technology, I look at what they are doing as again bringing in a new competitive model, that maybe the technology that they are using is going to give some efficiencies that provide a benefit to Mr. Damgard's constituencies and Mr. Green's.

And I just make those statements and just give any of you an opportunity to respond to them.

Mr. DUFFY. Well, I will be happy to take that for one second.

I mean, I think Congressman Gutknecht put it very appropriately. He said the horse is out of the barn. We did not want to be at this hearing today, Congressman. This isn't something that we all relished flying in the weather last night to come here for this hearing. This is not something we wanted. We want to comment on a complete application; that is all we wanted from the start.

Mr. DOOLEY. Just a second. Is the application process that Eurex is currently involved in, does it differ markedly from any other application in the way the CFTC has considered it? And the further requests for information by CFTC on a prior application, is there a clear difference in the terms of the approach?

Mr. DUFFY. It differs dramatically. When you are out marketing, as I said earlier, a certain way that you are going to conduct business to your clients, your clients expect you to do that. You don't go out and market something and then give them a wink and a nod

and say, We are not going to do it. So those are big concerns that we have.

When you put out a $40 million payment for order flow to your top 10 fiduciaries, when you put out that you are not going to say what products you are going to trade, but we all know what products we are going to trade. There are a lot of things there. When you talk about a cross-border clearing arrangement, OK, we are not going to put it in, we will self-certify later. We don't want to talk to the Treasury right now.

These are serious issues. These aren't something that the Chicago Mercantile Exchange brought to this committee hearing. We want an answer. That is all. It is not a big deal.

Mr. DOOLEY. If I can just respond, though, has CFTC passed judgment? Do they not still have the opportunity before they approve those products? Don't they still have to make a determination?

Mr. DUFFY. There is no question about it. Unfortunately, this was on a fast track, Congressman, as you are well aware, which would have been up November 16. So they could still have approved the application which——

Mr. DOOLEY. Didn't Mr. Newsome say that they could stay the 180 days if they didn't feel they had adequate information——

Mr. DUFFY. I don't have all the confidence in the world that—I don't work for the CFTC. I don't know what they are going to do. So that 180-day statute, I don't know what is going to happen. I think these issues are relevant and need to be raised.

Mr. CAREY. I would like to make a point. In the 2000 act, Congress set up a structure to expedite approvals for registered exchanges for rules and new contracts, but the special standards to become a registered exchange were intended to be rigorous and must be met first. We have been assured today, thanks to this hearing, that the highest standards of regulatory review will be applied to this Eurex U.S. application.

We also think the statute allows the CFTC to consider fair trade issues, which Chairman Duffy just mentioned, the fact that this was proposed in the public domain but not with the CFTC.

So we are grateful that they are going through this review process, but when they are stating that they are going to spend $40 million on an incentive program, or we have heard rumors of no charges for 2 years, or the fact that they will spend $100 million to gain steal this liquidity, as Werner Siefert has been quoted as saying, we think the statute allows the CFTC to consider fair trade issues. If Congress wants to make that explicit, we would support such a statutory amendment.

Mr. DAMGARD. Mr. Dooley, I would just like to say I agree with you, and I have great faith in the CFTC. I think Jim Newsome is an extremely competent, qualified public servant, and I believe that Jim Newsome knows more about this than perhaps anyone else.

I also think it is instructive to note that all the customers and everyone else believe that this application ought to be considered fairly and not with respect to anything other than what the experts believe is right or wrong, except the two Chicago exchanges who see them as a competitive threat. So I believe that you are right on target.

Mr. MCERLEAN. Congressman Dooley, I would like to say that our so-called "market materials" were materials that we used in bilateral meetings with some of our prospective clients. We have had no complaints from those clients regarding the discussions that we had. The only complaints have come from the exchanges that we plan to compete with in the future with.

Mr. MORAN [presiding]. Mr. Dooley, thank you very much.

I would like to indicate I think that this hearing is important, and appropriate. I think it is of great value to this committee, to Congress, to the American people, to investors.

I understand for the first time, when an application is being filed with CFTC under a new law, that we have every right and obligation to explore how that process works or doesn't work. I don't think it is the prerogative of this committee to make a decision as to whether or not CFTC should grant that application, but I think there is nothing wrong with the Members of Congress examining the effects of their legislative efforts.

This committee spent a lot of time and effort on a very difficult subject over many months, many years, in fact—trying to figure out what it is that we could do to improve the regulatory environment, create greater opportunities for investors as well as the exchanges to compete in a worldwide market.

And so I am delighted to have the opportunity to have the hearing and to see what is occurring in the markets and to examine how CFTC is performing their role.

I am delighted to have the opportunity to have the hearing and see what is occurring in the markets and to examine how CFTC is performing their role.

Mr. McErlean, I was not terribly interested in this question, until Chairman Goodlatte asked it, and I was not sure about the kind of reluctance or inability to answer the question, which was: Who do you report to and how are your board of directors selected?

Mr. MCERLEAN. The board will be selected, again, from investors. We are seeking investors in the Exchange. We announced that we are setting aside up to 20 percent of the Exchange ownership for U.S. investors. We will put together a board of 12, six of whom will come from a cross-section of the market; the other six will be some independent, some from the Eurex organization within Chicago.

Mr. MORAN. Those board members will initially invest in the U.S. company?

Mr. MCERLEAN. The organizations that the board members will represent may be investors.

Mr. MORAN. And then the question, again, about who you report to; in kind of the Kansas vernacular, who is your boss?

Mr. MCERLEAN. Here in the United States, I am the president and CEO, and if there is any legal or regulatory issue to address, I am the person that will address it. But Eurex U.S. is a U.S. company that is owned by U.S. Futures Exchange holdings, which is owned by Deutsche Boerse, and so I will report to someone in Frankfurt.

Mr. MORAN. You have stockholders now and the chairman on the board?

Mr. MCERLEAN. Right now we do have a stockholder. It is wholly owned by U.S. Futures Holdings, and that particular company does have a board or an ownership structure.

Mr. MORAN. The discussion about the clearing link back with Europe, as I understand it, that is an application you intend to file later.

Would you explain what you mean to the committee about the plans for the clearing link back with Europe?

Mr. MCERLEAN. Yes, sir. We are speaking to our vendors, our market participants, our clients, as well as our market partners, The Clearing Corporation in Chicago, and Eurex Clearing AG in Frankfurt about the parameters of how this clearing link will work.

When we are ready with the clearing link we think we have answered all the questions, we will come to the CFTC for approval. We thought that the process of this application would be going a lot quicker than we are experiencing, and so we have been put off track a little bit from that schedule.

Mr. MORAN. And the reason that that is a separate application as compared to part of the application now pending is?

Mr. MCERLEAN. That is regulatory approval that our DCO, that the clearing organization in Chicago will have to seek. That is not something we will seek.

Mr. MORAN. And can you describe the clearing relationship in Chicago and the clearing in Europe?

Mr. MCERLEAN. They would clear each other's products. From my understanding, the clearing organization in Europe, Eurex AG, would also have to register here in the United States to be a DCO, and there would be contractual relationships between the two.

Again, we would not do anything unless it was okayed under U.S. law and the oversight of the CFTC. And I would add that our marketing of a clearing link is not unusual. The CME and the CBOT announced the clearing link before they had CFTC approval. We are getting feedback from the market participants that there is value to be gained from a clearing link and trying to deliver the products that they would like to use in the future.

Mr. MORAN. My time has expired. Thank you very much, Mr. McErlean.

Mr. Etheridge.

Mr. ETHERIDGE. Thank you, Mr. Chairman.

I guess this will be for Mr. Carey and Mr. Duffy, if you would.

Can you tell me what your experience has been in regard to efforts that you have made to do business in Germany, as one example, and do you view the offers or the opportunities to do business there as having the same kind of expeditious licensure opportunities as we have here in this country?

Mr. DUFFY. I will tell you from experience that we have at the Chicago Mercantile Exchange, we tried to put a single trading terminal, one——

Mr. ETHERIDGE. Would you tell us what a trading terminal is?

Mr. DUFFY. It is our own terminal that gives access back to our own markets in Chicago. When we tried to put the terminal in, we were put at bay for over a year's time, and Eurex really flexed its political muscle; and, as I stated, I have a copy actually from our German lawyers, which I am willing to submit so the Members of

Congress can see the efforts we had to go through to try to put one single terminal in Germany, over a year, sir.

Mr. CAREY. Briefly, I would like to say that our counsel's opinion, which we have submitted for the record, indicates that we may not receive fair trade treatment if we sought to compete in Germany.

Also I would like to address an earlier question to Mr. McErlean. It said in the question-and-answer materials that were provided for the proxy for the shareholders at the clearing corporation, it says: Will the link be operational when Eurex launches Eurex-U.S?

The answer of the clearing corporation and Eurex is that they process of finalized the details of the link which is expected to become operational February 1, 2004, or shortly thereafter; so, again, that is why we appreciate this hearing. That is why this hearing was necessary, to comment on these inconsistencies.

Mr. ETHERIDGE. Thank you.

Mr. MCERLEAN. May I comment?

Mr. ETHERIDGE. Sure.

Mr. MCERLEAN. My first comment is if, when we started down that road, our application had gone through as quickly as we had planned, we would not have to be contemplating the timing of our clearing link.

My second comment is regarding reciprocity and bringing trading terminals either from the U.S. or Germany or Germany into the U.S., Eurex had a similar experience where it took about a year to get approval to put clearing or trading terminals——

Mr. DUFFY. I do not mean to interrupt, Mr. McErlean, but the correct number is 3 months.

Mr. MCERLEAN. But the process had started 10 months earlier.

May I comment on reciprocity, if you don't mind? We have identified no provision of German law that would preclude a U.S. or other non-German person from opening an exchange in Germany or impose special obstacles requirements on U.S. or other foreign persons. We have not seen any provision cited. It has been suggested that the German authorities would or could prevent a new exchange competitor.

However, we are aware of no such denials. None have been cited to us and the only known case is squarely to the contrary.

NASDAQ Deutschland—and I would note that Cantor Futures Exchange have put their terminals into Germany. Contrary to suggestion, in Germany, as in the U.S., an abuse of discretion by regulatory authority in applying the law may be challenged in court; and furthermore, you can go to any European country and you can pick the easiest one if you like, and register and passport automatically into Germany.

We have and would like to submit for the record an agreed list of criteria for the approval of a new exchange, a list that has been agreed by all exchange supervisory authorities and that does not include application of any exclusionary criteria of the type that has been suggested.

Mr. ETHERIDGE. Thank you.

When we are talking about these changes, we are talking about bonds and commodities, but you are also talking a lot about moving of monetary issues and how it has impacted on U.S. funds, et cetera.

Would you have any objection to your open case being reviewed by the U.S. Treasury Department and the Federal Reserve?

Mr. MCERLEAN. No, sir.

Mr. ETHERIDGE. If not, if the answer is you have no objection, then put this issue to rest. Would you consider asking the CFTC to submit your application for review? If the Treasury or the Fed requested information about the products you plan to offer, would you provide it?

Mr. MCERLEAN. Sir, we have given our application to the CFTC, and if they would like to have it reviewed by the Treasury or the Fed, that is their prerogative and we would not object.

Mr. ETHERIDGE. OK, but that was not my question.

Mr. MCERLEAN. Then could you repeat your question, please, sir?

Mr. ETHERIDGE. My question was if you have no objection, would you submit it to the Treasury or to the Federal Reserve for review?

Mr. MCERLEAN. If we had an objection of how the CFTC was——

Mr. ETHERIDGE. No, that was not my question. Let me repeat it, if I may, Mr. Chairman. I realize my time has run out.

Would you have any objection to your application being reviewed by the U.S. Trade and Treasury and Federal Reserve?

Mr. MCERLEAN. Thank you.

Mr. ETHERIDGE. And I said if not, to put it to rest, would you consider asking the CFTC to submit your application for review by them?

Mr. MCERLEAN. We would have no objection, sir.

Mr. ETHERIDGE. So then you will ask them to submit it for review?

Mr. ROSEN. At the request of the CFTC, because he wanted to expedite that process, we yesterday provided them the contract specs specifically to facilitate the discussion of those terms with the Fed and the Treasury because we had no objections whatsoever to——

Mr. ETHERIDGE. So you have already moved in that area?

Mr. ROSEN. Yes, sir.

Mr. ETHERIDGE. OK. Thank you.

Mr. MORAN. Mr. Burns.

Mr. BURNS. Thank you, Mr. Chairman. I appreciate the time and the expertise. The panel has been very enlightening.

Mr. McErlean, I have been very concerned that the committee chairman asked a question and the subcommittee chairman asked a question about who you report to. This is not a sole proprietorship, this is not a situation where you are the sole owner of an enterprise. You report to somebody. And either you are unwilling or unable to respond; is that correct?

Mr. ROSEN. No, he is not unwilling to respond.

Mr. McErlean, because he is the chief executive officer——

Mr. BURNS. Can he speak for himself?

Mr. MCERLEAN. As the chief executive and president of the Exchange, I am responsible for all that goes on.

Mr. BURNS. I understand.

Are you the sole proprietorship of the Exchange?

Mr. MCERLEAN. And I would report to the organization in Frankfurt.

Mr. BURNS. And their name is?

Mr. MCERLEAN. Mr. Rudi Ferscha.

Mr. BURNS. Thank you. And he is?

Mr. MCERLEAN. He is CEO of Eurex AG.

Mr. BURNS. Thank you. I appreciate that.

Mr. Duffy, you discussed the potential for market squeeze and the potential problems with that for a layman. Would you please explain market squeeze?

Mr. DUFFY. I would be happy to, but I am citing from a 2001 Financial Times article related to the Bobl market squeeze that allegedly occurred, just so we understand that. But a market squeeze would be where a significant player would be able to buy enough of futures contract to manipulate the price to a certain level, especially when it goes unregulated, and the regulator is obviously charged with making certain that those positions are not to a point where no one can. On the opposite side, does not matter what the fundamentals are, if they just do not move, they can make the price do whatever they want. So that is up to the regulator to make that decision. And when I cited the Financial Times article, Eurex only reprimanded Deutsche Bank and the German Government did nothing in relation to it.

Mr. BURNS. Who are winners and losers in that situation?

Mr. DUFFY. The losers of that particular situation, sir, were the short position of individual investors who were hedging their portfolios in German debt.

Mr. BURNS. Is there any risk of similar type of concerns in the U.S. market?

Mr. DUFFY. I think there is always that problem. Because of the regulation we have in the U.S., we feel very well protected.

Mr. BURNS. OK.

Mr. McErlean, you care to respond to the concept of market squeeze?

Mr. MCERLEAN. I am not an employee of the Eurex Exchange in Europe, but from what I understand regarding the situation where there was a market squeeze, that the Eurex immediately addressed the problem by changing some of their delivery rules, and there has not been any such problems since.

Mr. BURNS. I want to shift gears and talk about surveillance.

I would like for Mr. Carey and Mr. Duffy and Mr. McErlean all to respond with your quick summaries of your surveillance and the extent to which you deal with your market surveillance; specifically, your allocation of resources, how many dollars it takes to do that, and how many staff that you think is appropriate, given the volume and the complexity of your markets.

Mr. Carey.

Mr. CAREY. Well, I would say the last numbers I have seen are that we have 85 employees and we allocate $19 million a year to market oversight, and that includes trade practices, avoiding anything like these squeezes and overall surveillance of our electronic markets and open outcry markets.

Mr. BURNS. Mr. Duffy.

Mr. DUFFY. We have at Chicago Mercantile 120 people in our regulatory department that are completely dedicated toward market surveillance. We have an annual budget of $20 million associ-

ated with that budget, to protect the safeguards of our institution and our customers.

Mr. BURNS. Mr. McErlean.

Mr. MCERLEAN. We have outsourced our market surveillance and that will be performed by the National Futures Association. We have every confidence in the NFA to be able to perform that function, as does the CFTC.

Mr. BURNS. And your budget?

Mr. MCERLEAN. We have one person on our staff right now that will be in charge of regulatory oversight and who will——

Mr. BURNS. One person to——

Mr. MCERLEAN. One person that will liaise with the NFA in terms of regulatory oversight.

Mr. BURNS. And your anticipated budget for regulatory oversight?

Mr. MCERLEAN. We are still developing a budget, sir. I do not have that answer for you. I would love to give that to you.

Mr. BURNS. I would appreciate it.

Mr. Roth, as the NFA and as the individual who will be providing the regulatory service agreements to U.S. Futures Exchange, I understand from your testimony that you have experience with, what, four different exchanges; is that correct?

Mr. ROTH. Well, we signed regulatory service agreements with four different exchanges but, Congressman, two of those have never traded.

Mr. BURNS. And consequently you said you have 100 on compliance staff.

What is your level of confidence that you have—for example, my question really is the current volume of surveillance you support versus the potential future volume of surveillance that you must support.

Mr. ROTH. Right. And it could very well be that USFE has greater volume than the exchanges that we provided services for in the past.

Mr. BURNS. Is that a likelihood?

Mr. ROTH. Well, I will tell you, Congressman, BrokerTec thought they were going to do pretty big volume, too. We have not talked with the Futures Exchange yet that has intended to have small volume, so I do not know whether that volume will be there or not.

What I do know is in making comparisons of this sort, it is very important that—I think the expression has been used several times today that we do an apples-to-apples comparison.

With respect to our services agreement with the USFE, plus the services that we are talking about, they do not include the market supervision function. They do not include performing audits of their members. They do not include financial analysis. All of that is something that NFA may be willing to do for them and may be willing to do, but there would be charges for all of those types of functions.

Also, our surveillance would not have to include personnel for any of these sorts of surveillance issues that are unique to open outcry issues.

With respect to the contract, the contract provides that if USFE never trades a single contract, they are obligated to pay approxi-

mately $600,000 a year, but as their volume goes up—that is just a minimum level, and as their volume goes up, the revenue that would be paid to NFA would go up. And we are confident that we can support an adequate staff to do the job.

The CFTC has reviewed our surveillance program on no fewer than five occasions. They have reviewed it with respect to each of the four previous applications for contract market designation. They have also reviewed it in the context of a rule enforcement review, and in each instance they found that NFA's programs met all of the statutory and regulatory requirements.

And the point I made in my testimony is the point I reiterate here: We made our estimates as to the type of staffing that would be appropriate, but if at any point—we have not made our reputation over the last 20 years by trying to scrimp on resources. We will do the job and we will do it right, and if that requires that USFE pay higher fees, then we will talk to them exactly about that.

Mr. DUFFY. Congressman Burns, you asked the rest of us to state on the record what we paid in annual budgets for our compliance regulatory framework. Mr. Roth has stated in his testimony that he is going to do these functions.

I believe it would only be fair that he states on the record what his first-year agreement would be, understanding that it is an upstart company with a $6 billion market cap company behind it. I understand it is an upstart, but I would like to know if there are caps involved in this agreement or what the first annual year would be of revenue.

Mr. ROTH. There are caps involved. The amount to be paid by USFE depends on volume. There is a minimum for the narrow services that I described of approximately $600,000 in the first year. It could be as high as approximately $3 million in the first year.

Mr. BURNS. For an estimated volume?

Mr. ROTH. For instance, if their volume gets up to 25 percent of the Chicago Board of Trade's volume, we would have staffing and funding to provide funding for approximately 25 staff people, which we think is adequate.

If that is not adequate, if we are wrong, we will devote the staff necessary to do that, and we will turn to USFE and suggest that either they renegotiate the fees to ensure that we are recovering our cost or they search around for another regulator.

Mr. BURNS. Thank you, Mr. Chairman.

Mr. MORAN. Both Mr. Burns' and Mr. Duffy's time has expired.

Mr. DUFFY. Come on; could I have some of Mr. Damgard's?

Mr. MORAN. The gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman.

Mr. McErlean, were you here earlier when Mr. Newsome testified?

Mr. MCERLEAN. Yes, sir, I was.

Mr. MARSHALL. Then you heard the nature of my questions, then, and you may not recall them, but I am interested in transparency of the process. I trust that as long as everybody sees what is on the table, then the right questions will be asked, the right inquiries made, and proper decision will be made by CFTC.

In response to my question, Mr. Newsome said: Well, some of the stuff that we are given by United States Futures Exchange is proprietary and we do not reveal it. We reveal as much as we think we possibly can.

What is it in your application, 2,000 pages long, that you consider to be proprietary that somehow these folks will not be able to figure out; I mean, it does not seem to me—well, actually, from my perspective, it does sound a bit like alchemy, but I doubt from the perspective of anybody in the room it is.

I doubt that there are too many things that are truly major secrets that you need to worry about; and as far as this committee is concerned, certainly this member is concerned, your willingness to be very public with as much of your application that you possibly can brings me comfort that the process of oversight and regulation that CFTC must go through is one that will work, because it is open, it is not behind closed doors. It is not something that the public would really worry about as long as those who are concerned, who are here as experts, have a fair shot of saying hey, this does not comply with one of the 18 requirements, that sort of thing.

So what are you trying to hide that you are not willing to make public?

Mr. MCERLEAN. Well, sir, thank you very much for that question.

We were not trying to hide anything that would damage our competitive position or reveal to the market what some of the commercial contracts that we have in place with some of our service providers are, for competitive reasons and for reasons I think that the Exchange or the CFTC intended; that you do not necessarily want to make public to the markets specific things in terms of how you are going to conduct market oversight in your markets, because then you are giving the keys of the hen house to the fox. Everyone would have that information and know how to circumvent those rules.

Mr. MARSHALL. The market oversight, those being provided by Mr. Roth; is that correct?

Mr. MCERLEAN. Correct.

Mr. MARSHALL. But pursuant to rules that you are establishing?

Mr. MCERLEAN. We have a contractual relationship with the NFA as well as with The Clearing Corporation in Chicago, as well as with Deutsche Boerse Systems, Incorporated, to provide us with the——

Mr. MARSHALL. Are you familiar with the market oversight rules, whatever process is followed by the board and the Exchange? Are you familiar with what they do with their $19 million and $20 million?

Mr. MCERLEAN. Yes. But because we do not have to support a trading floor, that our budget will be able to be a lot less.

Mr. MARSHALL. I fully accept that. That is obvious. But will you be doing the same things?

Mr. MCERLEAN. Yes, we will.

Mr. MARSHALL. So what is the secret?

Mr. MCERLEAN. We will have large trader reports and we will make those available to both the NFA and the CFTC.

Mr. MARSHALL. I take it that neither of the other two exchanges makes this information public?

Mr. ROTH. Congressman, with respect to the regulatory services agreement between NFA and USFE, the portion that is sensitive to us is that schedule which details how we will conduct surveillance. And we would not want that to be made public, so as to give anyone a road map to avoid that surveillance or circumvent that surveillance. That is the only part of the regulatory agreement that we find sensitive.

Mr. MARSHALL. What other proprietary information is included in your application, despite this concern about the regulatory process?

Mr. MCERLEAN. Just the commercial aspects that deal with our relationships with our service providers.

Mr. MARSHALL. And nothing other than that? Are those the only things that have not been made public thus far?

Mr. MCERLEAN. That is correct.

Mr. MARSHALL. So you are familiar with——

Mr. MCERLEAN. The contract specifications.

Mr. MARSHALL. What contract?

Mr. MCERLEAN. The contract that we will trade on this new exchange.

Mr. MARSHALL. They have not been released?

Mr. MCERLEAN. They have been provided to the CFTC yesterday.

Mr. MARSHALL. And are these the contracts that you have been floating with possible large traders?

Mr. MCERLEAN. These are the contracts that we originally announced back in September when we submitted our application, but we were still discussing the contract specifications of them until recently.

Mr. MARSHALL. I see my time has expired, Mr. Chairman.

I would simply encourage you to reveal absolutely as much as you possibly can as part of this process, because you are going to hear from this committee, and others, repeated complaints about transparency and the need for transparency.

Mr. MORAN. Thank you, Mr. Marshall.

Mr. Stenholm.

Mr. STENHOLM. No additional questions.

It just seems to me that having listened to much of the testimony today, reading and visiting, that the process is working as was intended. CSMA was designed to deal with just a situation like we are now watching CFTC deal with, and it is being done in a way that I think everyone intended that it should be done.

I was asked just a moment ago that question and I thought I would respond on the record. The gentleman from Georgia, Mr. Marshall, asked it, talking about the question we are talking about, transparency. That is something that customers—in this case today, we are not talking about cotton farmers and the wheat farmers as far as we are talking about the citizens of the United States, I guess the customers of the tremendous job that the America and the Chicago Board have done and are doing and Eurex wishes to do in the United States, that which they have been doing worldwide.

We all want a level playing field. We all want the rules to be followed. And with some of the public not only concerns, but the exposure now of wrongdoing that SEC and others have been coming up

with, the latest being something that just shocked everyone, that the mutual fund industry was in fact playing hanky-panky with doing the things. When you are talking about trading around, that sounds like somebody is going around the rules. Well, that is not really what it is, but it could be, and CFTC, that is what they are here for.

When we start talking about self-regulation, that always makes me a little bit nervous, but I do not get near as nervous about self-regulation if somebody is standing by with a good tree and a rope, appropriate horse, prepared to deal with the problem. And if there is anybody trading around and making money and putting it in their own pocket as a result of the rules and regulations that we think we have played that would protect them through transparency—just want you to know, Kansas and Texas got a pretty good reputation for ropes and trees. The chairman says Kansas has got a better reputation. Georgia would probably be right there with us.

And this hearing today, I think, is a perfect example of what this committee is all about. I think everyone at the table, there is some differences—well, probably not differences of opinion as much as concerns about the process working in the way in which it was intended, and I think this hearing has been very complimentary to that process.

We will continue to exercise our oversight, oversee FTC, and continue to be very concerned about the point that Mr. Marshall raised in his last question.

So, Mr. Chairman, I thank you for providing for this hearing.

Mr. MORAN. Mr. Stenholm, thank you very much.

Mr. Stenholm gave me the opportunity to speak about trees and horses and ropes, and I concluded that no one could deliver that scenario better than Mr. Stenholm.

It is, I think, as I said earlier, a very useful hearing. I appreciate the patience of our witnesses. It has been a long morning, into the afternoon.

I appreciate the long time that Chairman Newsome spent with us, and I am always pleased by the expertise that he demonstrates. We recognize that there are significant issues that are presented at the table here in this panel, and our committee is very interested in playing our role as oversight at CFTC.

Without objection, the record of today's hearing will remain open for 10 days to receive additional material and supplementary written responses from witnesses to any question posed to them by a member of this panel.

This hearing of the House Committee on Agriculture is now adjourned.

[Whereupon, at 1:40 p.m., the committee was adjourned.]

[Material submitted for inclusion in the record follows:]

STATEMENT OF JAMES E. NEWSOME

Thank you Chairman Goodlatte and members of the committee. I appreciate the opportunity to testify before you today on behalf of the Commission regarding the application filed by U.S. Futures Exchange, L.L.C. (U.S. Futures Exchange or Exchange) to become a designated contract market, which is commonly referred to as a futures exchange.

As you know, through the Commodity Futures Modernization Act of 2000 (CFMA), Congress profoundly altered the manner in which derivatives markets are regulated in the United States by replacing the one-size-fits-all prescriptive rules of the past with broad core principles aimed at promoting responsible innovation and fair competition among exchanges and other market participants. This is an exciting time for the futures business. Due to a number of factors, the industry that we regulate has grown significantly over the past few years. We believe that a primary contributing factor is the modernized regulatory structure established by Congress in the CFMA. This new, flexible approach to regulation has encouraged innovation and the use of cutting-edge technology, and has allowed market participants to implement business plans with much greater ease. It has also resulted in an unprecedented number of new entrants into the marketplace. Since December 2000, when the CFMA was signed into law, the Commodity Futures Trading Commission has designated four new exchanges as contract markets and has received three additional applications, including the application filed by U.S. Futures Exchange. Throughout this time the CFTC has been committed to providing a level regulatory playing field for all existing and potential market participants, while being vigilant in its mission to foster markets free of fraud and manipulation, and it will evaluate U.S. Futures Exchange's application accordingly.

To put things into context, I would first like to outline the legal requirements for contract market designation set forth in the Commodity Exchange Act (Act), as amended by the CFMA, and in the Commission's regulations. I will also outline the substance of U.S. Futures Exchange's application, including a description of its proposed clearing plans and how it intends to fulfill its self-regulatory responsibilities, and describe the process by which the Commission is evaluating the application. Finally, because questions have been raised concerning the Commission's authority to address activity occurring abroad that may relate to the Exchange's operations, I will comment on the Commission's authority to reach extraterritorial conduct.Legal Requirements for Contract Market Designation

To become a designated contract market (DCM), an applicant must demonstrate to the Commission that it will comply with the conditions set forth in the Act, which consist of eight designation criteria and eighteen core principles, and must provide sufficient assurance that it will continue to comply with those conditions. (The details of the designation criteria and the core principles are attached as an appendix). By statute, the Commission must approve or deny an application for designation within 180 days of its submission, unless the application is materially incomplete, in which case the 180-day period may be stayed. See section 6(a) of the Act.

By regulation, an application may be considered under a 60-day procedure in appropriate circumstances. See Commission Rule 38.3. Although originally slated for 60-day review, the Commission decided to remove the application from the expedited procedure and is now reviewing it under the 180-day statutory timeframe to ensure that we have an adequate opportunity to fully consider all of the issues.

In order to be complete, an application must include: (1) a copy of the applicant's rules and any technical manuals, guides, or instructions for users of the market; (2) descriptions of the trading system, test procedures and results, and contingency or disaster recovery plans; (3) descriptions of the applicant's legal status and governance structure; (4) copies of agreements, including third-party regulatory service agreements, that will enable the applicant to meet the conditions for designation; and (5) to the extent that it is not self-evident, an explanation as to how the application satisfies the conditions for designation.

The Act provides further that an exchange shall have reasonable discretion in establishing the manner in which it achieves compliance with the core principles, and may do so by delegating relevant functions to a registered futures association or another registered entity. In adopting rules implementing the Act, the Commission recognized that some existing exchanges had outsourced certain of these functions to non-registered entities, and determined that such outsourcing is permissible. See 66 Fed. Reg. 42256, 42266 (Aug. 10, 2001). In either case, however, the exchange remains ultimately responsible for assuring compliance.

U.S. FUTURES EXCHANGE'S APPLICATION

U.S. Futures Exchange formally applied for designation as a contract market on September 16, 2003. According to its application, U.S. Futures Exchange is a Delaware limited liability company headquartered in Chicago, and is a wholly owned subsidiary of U.S. Exchange Holdings, Inc., a separately capitalized, wholly owned subsidiary of Eurex Frankfurt A.G. (Eurex Frankfurt). Eurex Frankfurt is a wholly owned subsidiary of Eurex Zurich A.G., which is owned in equal parts by Deutsche Borse A.G. and SWX Swiss Exchange. U.S. Futures Exchange will be governed by

a Board of Directors elected each year at its annual meeting of shareholders. The Board will appoint a Chairman, and the Chairman may appoint a President, who will serve as Chief Executive Officer of the U.S. DCM.

All trading on the Exchange will be done electronically, through a version of the trading system that Eurex Frankfurt has operated in the U.S. since the year 2000 in a joint venture with the Chicago Board of Trade. The trading system will provide a full audit trail of orders, bids and transactions. Audit trail information will be submitted directly to the National Futures Association (NFA), a Commission-registered futures association, which will provide certain self-regulatory services for the Exchange such as conducting surveillance for trade practice violations, market manipulation, price distortions and market congestion. U.S. Futures Exchange staff in Chicago will conduct real-time monitoring of Exchange trading activity. Clearing and settlement services will be provided by The Clearing Corporation (formerly the Board of Trade Clearing Corporation), a derivatives clearing organization (DCO) registered with the Commission.

As with all applications for contract market designation, Commission staff is currently reviewing U.S. Futures Exchange's application to determine whether the operations described and the supporting technical and regulatory services agreements demonstrate that the Exchange meets the eight criteria for designation and the eighteen core principles. With respect to the proposed outsourcing of self-regulatory functions to NFA, in addition to reviewing the terms of the services agreement, prior to designation Commission staff will, among other things, conduct on-site examinations to determine whether appropriate surveillance systems are in place and functional. In the event that the Commission approves the provision of regulatory services by NFA, the Commission will monitor NFA's performance on an ongoing basis through rule enforcement reviews, as it does for all self-regulatory organizations.

The Commission has published for public comment all portions of the application except for those containing trade secrets or commercial or financial information subject to confidential treatment under the law. In considering whether to approve the application, the Commission will carefully consider all comments received.

ISSUES RAISED

There are two issues that have been raised in various forums, including questions from this committee, that the current application before the Commission does not address: (1) a proposed clearing link with Eurex Clearing A.G. (Eurex Clearing), which is the clearing and settlement arm of Eurex Frankfurt; and (2) proposed incentive programs for attracting business to the Exchange.

CLEARING LINK

The application currently pending before the Commission does not request approval of trade clearing or settlement arrangements outside the U.S. As mentioned earlier, the clearing component of the application is based upon the proposed clearing services agreement with The Clearing Corporation. Although U.S. Futures Exchange has publicly announced that it intends to offer a clearing link with Eurex Clearing at some point in time, it has not presented the Commission with any cross-border clearing plans. Neither the Act nor the Commission's regulations require that an application for designation as a contract market include all future clearing plans that may be contemplated, or future plans in general. The application need only include information demonstrating an ability to satisfy the conditions for designation based upon a current business plan. Because we can consider only the proposal contained in the application, the Commission's review of the clearing component of the application is currently proceeding strictly on the basis of the proposed clearing services agreement with The Clearing Corporation.

Although the Commission does not know the particulars of the Exchange's future plans for a cross-border clearing link, the Commission can assure the committee that any proposal that would permit the clearing of U.S. Futures Exchange positions by Eurex Clearing would require that Eurex Clearing first become a U.S. DCO. See sections 5(b)(5) and 5(d)(11) of the Act and applicable part 38 Guidance. In accordance with Commission policy, those portions of any application filed by Eurex Clearing to become a DCO that are not subject to a request for confidential treatment under the Freedom of Information Act or Commission regulations would be released to the public for comment.

It is conceivable that a proposal to enable Eurex Clearing to clear U.S. Futures Exchange positions could be considered under other provisions of the Act or regulations, but any such proposal would require affirmative Commission action, which would not be taken without the opportunity for public comment.

INCENTIVE SCHEMES

U.S. Futures Exchange has not presented the Commission with any plans for generating volume on the Exchange. Incentives aimed at generating trading volume on futures exchanges, such as "fee holidays" for new products and reduced fees for market makers, have long been viewed as acceptable by the Commission. Most U.S. exchanges offer such incentives in the normal course of business. Commission staff analysis of these programs focuses primarily on whether the incentive will distort open, competitive and efficient trading in the product by making abusive practices, such as wash trading, economically attractive. In addition to the foregoing review, the Commission would review any marketing plan offered by U.S. Futures Exchange, as it would from any other applicant or registrant, to determine whether its implementation would pose an impermissible conflict of interest between brokers and the fiduciary duties owed to customers. I would like to emphasize that the Commission will not allow U.S. Futures Exchange to offer any incentive program that other U.S. contract markets would not be permitted to offer.

THE COMMISSION'S EXTRATERRITORIAL ENFORCEMENT AUTHORITY

The fact that U.S. Futures Exchange is owned by a German company has led to questions concerning the CFTC's authority to prosecute foreign individuals. In recognition of the international nature of commodity futures and option trading, Congress has given the Commission broad powers to take actions against persons suspected of violating the Act wherever such persons may be located, and to serve subpoenas seeking the production of witnesses and documents wherever they may be located. See, e.g., sections 6(c), 6b and 6c(a) of the Act. In addition, the Commission may prosecute any person located abroad who, directly or indirectly, controls a person who commits a violation of the Act. See section 13(b) of the Act.

To enhance its extraterritorial enforcement powers, the Commission has entered into numerous bilateral information-sharing arrangements (also known as Memorandums of Understanding or MOUs) with foreign regulators. With respect to Germany in particular, the Commission has enjoyed a long-standing and extensive cooperative relationship with the Bundesanstalt fur Finanzdienstleistungsaufsicht (BaFin), our German counterpart, and its predecessor agency. The BaFin's cooperation has been critical to the Commission's ability to combat violations in a number of instances, by assisting our Division of Enforcement in obtaining trading and bank records, registration histories, complaint and investigation files, and most recently, obtaining the statement of a witness. The Commission fully expects, based upon its past experience with the BaFin, that should circumstances require assistance from Germany in connection with U.S. Futures Exchange's operations, such assistance will be forthcoming in accordance with the provisions of the MOU.

It should be noted that, to the extent the Commission may encounter difficulty in pursuing violations of the Act or regulations committed by persons who are located abroad, that issue exists today with respect to activity conducted by foreign persons on existing U.S. exchanges. Furthermore, there is no prohibition on foreign persons serving as senior executives or board members of U.S. exchanges, and a number of non-U.S. citizens have done so.

In closing, I would like to emphasize that U.S. Futures Exchange has applied to become a U.S. exchange that will be subject to the CFTC's direct regulatory authority. The Commission takes its responsibilities in reviewing applications for contract market designation seriously, and will apply the highest standards of regulatory review prior to approving the application made by U.S. Futures Exchange. We pledge to you that we will review the application, mindful of all comments received, with an eye toward ensuring that all necessary standards are met, and that only sound, ethical business practices are allowed to exist in the U.S. marketplace. I thank you for the invitation to appear today, and will be happy to answer any questions you may have.

APPENDIX

CRITERIA FOR DESIGNATION

The eight criteria for designation as a contract market are as follows:

(1) IN GENERAL—To be designated as a contract market, the board of trade shall demonstrate to the Commission that the board of trade meets the criteria specified in [the Act].

(2) PREVENTION OF MARKET MANIPULATION—The board of trade shall have the capacity to prevent market manipulation through market surveillance, compliance, and enforcement practices and procedures, including methods for con-

ducting real-time monitoring of trading and comprehensive and accurate trade reconstructions.

(3) FAIR AND EQUITABLE TRADING—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. The rules may authorize:

(A) transfer trades or office trades;

(B) an exchange of:

(i) futures in connection with a cash commodity transaction;

(ii) futures for cash commodities; or

(iii) futures for swaps; or

(C) a futures commission merchant, acting as principle or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if the contract is reported, recorded, or cleared in accordance with the rules of the contract market or a derivatives clearing organization.

(4) TRADE EXECUTION FACILITY—The board of trade shall:

(A) establish and enforce rules defining, or specifications detailing, the manner of operation of the trade execution facility maintained by the board of trade, including rules or specifications describing the operation of any electronic matching platform; and

(B) demonstrate that the trade execution facility operates in accordance with the rules or specifications.

(5) FINANCIAL INTEGRITY OF TRANSACTIONS—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.

(6) DISCIPLINARY PROCEDURES—The board of trade shall establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market participants that violate the rules of the board of trade, or similar methods for performing the same functions, including delegation of the functions to third parties.

(7) PUBLIC ACCESS—The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade.

(8) ABILITY TO OBTAIN INFORMATION—The board of trade shall establish and enforce rules that will allow the board of trade to obtain any necessary information to perform any of the functions describe in the [criteria for designation], including the capacity to carry out such international information-sharing agreements as the Commission may require.

7 U.S.C. § 5(b).

CORE PRINCIPLES

The thirteen core principles for contract markets are as follows:

(1) IN GENERAL—To maintain the designation of a board of trade as a contract market, the board of trade shall comply with the core principles specified in [the Act]. The board of trade shall have reasonable discretion in establishing the manner in which it complies with the core principles.

(2) COMPLIANCE WITH RULES—The board of trade shall monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.

(3) CONTRACTS NOT READILY SUBJECT TO MANIPULATION—The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.

(4) MONITORING OF TRADING—The board of trade shall monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.

(5) POSITION LIMITATIONS OR ACCOUNTABILITY—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 speculators where necessary and appropriate.

(6) EMERGENCY AUTHORITY—The board of trade shall adopt rules to provide for the exercise of emergency authority, in consultation or cooperation with the Commission, where necessary and appropriate, including the authority to——

(A) liquidate or transfer open positions in any contracts;

(B) suspend or curtail trading in any contracts; and

(C) require market participants in any contract to meet special margin requirements.

(7) AVAILABILITY OF GENERAL INFORMATION—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.

(8) DAILY PUBLICATION OF TRADING INFORMATION—The board of trade shall make public daily information on settlement prices, volume, open interest, and opening and closing ranges for actively traded contracts on the contract market.

(9) EXECUTION OF TRANSACTIONS—The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions.

(10) TRADE INFORMATION—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.

(11) FINANCIAL INTEGRITY OF CONTRACTS—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), and rules to ensure the financial integrity of any futures commission merchants and introducing brokers and the protection of customer funds.

(12) PROTECTION OF MARKET PARTICIPANTS—The board of trade shall establish and enforce rules to protect market participants from abusive trading practices committed by any party acting as an agent for the participants.

(13) DISPUTE RESOLUTION—The board of trade shall establish and enforce rules regarding and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries.

(14) GOVERNANCE FITNESS STANDARDS—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.

(15) CONFLICTS OF INTEREST—The board of trade shall establish and enforce rules to minimize conflicts of interest in the decisionmaking process of the contract market and establish a process for resolving such conflicts of interest.

(16) COMPOSITION OF BOARDS OF MUTUALLY OWNED CONTRACT MARKETS—In the case of a mutually owned contract market, the board of trade shall ensure that the composition of the governing board reflects market participants.

(17) RECORDKEEPING—The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the Commission for a period of 5 years.

(18) ANTITRUST CONSIDERATIONS—Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall endeavor to avoid——

(A) adopting any rules or taking any actions that result in any unreasonable restraints of trade; or

(B) imposing any material anticompetitive burden on trading on the contract market.

7 U.S.C. § 5(d).

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Office of the
Chairman

December 19, 2003

The Honorable Robert W. "Bob" Goodlatte
Chairman
Committee on Agriculture
United States House of Representatives
Washington, DC 20515

Dear Chairman Goodlatte:

Enclosed please find my responses to written questions submitted for the record by Representatives Boehner, Peterson, and Gutknecht following the Committee's November 6, 2003 hearing to "Review the Application for Contract Market Designation of the United States Futures Exchange before the Commodity Futures Trading Commission." I have also enclosed additional information in response to comments and questions raised during the hearing. I request that this information be made a part of the hearing record.

Sincerely,

James E. Newsome

cc: The Honorable Charles W. Stenholm

Follow-up to Hearing

In response to Rep. Pomeroy's request during the hearing for information concerning the ability of the Commission to protect the U.S. public interest when the entity in question is foreign-owned, the following information is supplied for the record.

The Commission has comprehensive powers to investigate and prosecute violations of the Commodity Exchange Act ("Act"), Commission regulations, and Commission orders. The Commission's authority under the Act reaches beyond the territorial limits of the U.S. to wherever persons or information may be located. Where persons and information are located abroad, the Commission can invoke the aid of federal district courts and its enforcement counterparts around the globe.

If an exchange violates the Act, Commission regulations, or Commission orders, the Commission may investigate and: (1) take administrative action against the exchange in accordance with Sections 6(b) and 6b of the Act; (2) file a civil injunctive action against the exchange under Section 6c(a); or (3) take emergency action under Section 8a(9) of the Act, if deemed necessary. The Commission also may take action against any director, officer, agent or employee of an exchange, or any other person, including controlling persons of an exchange (Section 13(b) of the Act), and aiders and abettors (Section 13(a)) who violate the Act, Commission regulations, or Commission orders, pursuant to Sections 6(c), 6(d), 6b and 6c of the Act.

For the purpose of any investigation or proceeding under the Act, the Commission may administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records that the Commission deems relevant or material to the inquiry. The attendance of witnesses and the production of any such records may be required from any place in the United States, any State, or any foreign country or jurisdiction at any designated place of hearing.

Subpoenas seeking the production of witnesses or records located outside the U.S. are served in accordance with the procedures prescribed by the Federal Rules of Civil Procedure for service of process in a foreign country. If a U.S. citizen or foreign person located outside the U.S. refuses to honor a subpoena, the Commission may bring a subpoena enforcement action in a U.S. federal court, which may issue an order compelling the attendance of the witness or the production of the documents sought by the subpoena. A person who fails to obey such an order, foreign or domestic, is subject to being found in contempt of court and could be subject to a fine or imprisonment as a result. In the case of a foreign person, any assets of the foreign person found in the U.S. could be attached to satisfy a fine, and the person could be imprisoned upon entry into the U.S.

The Commission may bring administrative enforcement actions pursuant to Sections 6(b) and 6b of the Act against any exchange if it fails to enforce its rules, or otherwise is violating the Act, Commission regulations, or orders. In addition, the Commission can take action against any director, officer, agent, or employee of any exchange, wherever located, for violations of the Act, regulations, or orders of the Commission. Sanctions for such violations include suspension or

revocation of contract market designation, cease and desist orders, and civil penalties of up to $500,000 per violation.

The Act also provides for controlling person liability. In particular, Section 13(b) of the Act states that:

> Any person who, directly or indirectly, controls any person who has violated any provision of this Act or any of the rules, regulations, or orders issued pursuant to this Act may be held liable for such violation in any action brought by the Commission to the same extent as such controlled person. In such action, the Commission has the burden of proving that the controlling person did not act in good faith or knowingly induced, directly or indirectly, the act or acts constituting the violation.

Thus, if a controlling person were to knowingly, or in bad faith, induce an exchange to violate the Act or regulations, either directly or indirectly, he or she would be subject to prosecution by the Commission. The determination of who constitutes a "controlling person" is made on a case-by-case basis.

Moreover, if circumstances were to develop that could threaten the orderly trading in or liquidation of any futures contract, or give rise to concerns regarding actual or threatened manipulations or corners, the Commission could exercise its emergency authority. With respect to emergencies, Section 8a(9) authorizes the Commission:

> to direct the exchange, whenever it has reason to believe that an emergency exists, to take such action as in the Commission's judgment is necessary to maintain or restore orderly trading in or liquidation of any futures contract, including, but not limited to, the setting of temporary emergency margin levels on any futures contract, and the fixing of limits that may apply to a market position acquired in good faith prior to the effective date of the Commission's action. The term "emergency" as used herein shall mean, in addition to threatened or actual market manipulations and corners, any act of the United States, or a foreign government affecting a commodity or any other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for such commodity.

In addition to the Commission's powers to bring an action against an exchange, Sections 6(c) and 6(d) of the Act empower the Commission to bring administrative enforcement actions against any person other than an exchange for violations of the Act, regulations, or Commission orders. The Commission can serve administrative complaints in such actions without limitation as to where such persons are located. Administrative actions can result in civil penalties of up to $120,000 per violation, or triple the monetary gain to such persons, as well as trading prohibitions, and cease and desist orders.

In addition to its administrative enforcement authority, under Section 6c(a) of the Act, the Commission can file a civil injunctive action in federal court against any person, including an

exchange, when it appears that the person "has engaged, is engaging, or is about to engage in any act or practice constituting a violation of any provision of [the] act, or any rule, regulation, or order thereunder, or is restraining trading in any commodity for future delivery." Again, there is no limitation on where the person may be located.

To enhance its enforcement powers abroad, the Commission has entered into numerous formal, bilateral enforcement information sharing arrangements (also known as "Memorandums of Understanding" or "MOUs") with foreign derivatives regulators, including the Commission's German counterpart, the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"), and its predecessor agency, the Bundesaufsichtsamt für Den Wertpapierhandel ("BAWe"). Under the bilateral MOU, signed on October 17, 1997, the BaFin and the CFTC have committed to provide each other with the fullest assistance permissible under the laws of the United States and Germany, in order to facilitate: (1) market oversight, including market and financial surveillance; (2) the grant of licenses, authorizations, waivers or exemptions for the conduct of futures businesses and futures processing businesses; (3) the inspection or examination of futures businesses and futures processing businesses; and (4) the investigation, litigation, or prosecution by the CFTC, or the BaFin, of activity that potentially violates the futures laws or regulations applicable in their respective jurisdictions, without regard to whether the activity described in the request for assistance would constitute a violation of the futures laws or regulations applicable in the jurisdiction of the regulator providing assistance.

The assistance available under the MOU includes, without limitation: (1) providing access to information in the files of the regulator; (2) taking statements of persons; (3) obtaining information and documents from persons; and (4) inspecting or examining futures contracts, futures businesses, and futures processing businesses. The MOU provides further that, in circumstances where the regulator does not possess the legal authority to provide the assistance or information requested, it will use all reasonable efforts to obtain the aid of such other governmental agencies that can provide the assistance or information. The MOU also provides that, to the extent permitted by the laws and regulations of their respective jurisdictions, each regulator will use reasonable efforts to provide the other with any information it discovers that gives rise to a suspicion of a breach, or anticipated breach, of the laws or regulations applicable in the jurisdiction of the other. In requesting and providing assistance, the MOU contemplates an exchange of letters between the regulatory authorities, but in urgent circumstances such requests may be effected by summary procedures transmitted by other means of communication, provided that such communication is later confirmed in writing.

The BaFin's cooperation has been critical to the Commission's ability to combat violations in a number of instances, by assisting our Division of Enforcement in obtaining trading and bank records, registration histories, complaint and investigation files, and most recently, obtaining the statement of a witness. The Commission fully expects, based upon its longstanding, cooperative relationship with the German authorities under the bilateral MOU and under prior, less formal arrangements, that should circumstances require assistance from Germany in connection with U.S. Futures Exchange's operations, such assistance will be forthcoming in accordance with the provisions of the MOU.

More recently, the BaFin reaffirmed its commitment to international information sharing by becoming a signatory, along with the Commission and twenty-two other regulatory authorities so far, to the Multilateral Memorandum of Understanding Concerning Consultation, Cooperation and the Exchange of Information of the International Organization of Securities Commissions ("IOSCO MOU") announced by IOSCO and the Commission on October 16, 2003. The IOSCO MOU is similar in scope to the bilateral MOU described above, but also provides two unique features. First, each signatory is required to pass a rigorous screening process to ensure that the signatory has the necessary powers to comply with the MOU's provisions. Second, cooperation under the MOU is overseen by a Monitoring Group comprised of MOU signatories, which is empowered to review noncompliance by MOU partners.

In response to Rep. Stenholm's request during the hearing for a description of the governance structure of U.S. Futures Exchange in terms of its board, its executives, and how its structure will compare to governance structures at other U.S. exchanges, the following information is supplied for the record.

A. The relevant provisions of the Commodity Exchange Act ("Act") and the manner in which U.S. Futures Exchange proposes to comply with them

There are two primary provisions of the Act that are relevant to the governance structure of a non-mutually owned designated contract market ("DCM"): (1) Section 5(d)(14) (Core Principle Fourteen), which requires DCMs to establish and enforce appropriate fitness standards for directors; and (2) Section 5(d)(15) (Core Principle Fifteen), which requires DCMs to establish and enforce rules to minimize conflicts of interest in the decision-making process and to establish a process for resolving such conflicts of interest.

In accordance with Commission guidance on how to comply with Core Principle Fourteen, U.S. Futures Exchange's bylaws establish eligibility requirements for directors and members of any arbitration panel, oversight panel, or disciplinary committee, including requirements that each director be at least eighteen years of age, and that no individual is eligible to serve if such individual:

- has been found within the prior three years to have committed a disciplinary offense;
- has entered into a settlement agreement within the prior three years that included a disciplinary offense;
- is suspended from trading on any contract market, is suspended or expelled from membership in any self-regulatory organization, is serving any sentence or probation, or owes any portion of a fine pursuant to specified conditions;
- is subject to an agreement with the Commission or any self-regulatory organization not to apply for registration with the Commission or membership in any self-regulatory organization;
- has been subject to, within the prior three years, a Commission registration revocation or suspension in any capacity for any reason, or has been convicted of any of the felonies listed in Section 8a(2)(D)(ii) through (iv) of the Act; or

- is subject to a denial, suspension or disqualification from serving on a disciplinary committee, arbitration panel or governing board of any self-regulatory organization as that term is defined in Section 3(a)(26) of the Securities Exchange Act of 1934.

In order to verify fitness information, U.S. Futures Exchange has stated that it will conduct an independent inquiry to substantiate the fitness information that directors will be asked to provide, which will include verification of fitness using BASIC (a National Futures Association database) and other similar databases. Directors will be asked to certify that they meet the governance fitness standards, and these certifications will be provided to the Commission.

In accordance with Core Principle Fifteen, U.S. Futures Exchange has established rules to minimize conflicts of interest in the decision-making process of the contract market and has established a process for resolving such conflicts of interest. These rules include a prohibition on voting on or participating in deliberations, or taking any action on any matter involving a named party in interest, if the board or committee member:

- is the named party in interest;
- is an employer, employee, or fellow employee of the named party in interest;
- has any other significant, ongoing business relationship with a named party in interest; or
- has a family relationship with a named party in interest.

In addition, prior to considering any matter involving a named party in interest, each member must disclose to the Chief Executive Officer ("CEO") whether the member has any of the foregoing relationships with the named party in interest. The CEO will then determine, based upon the information available and the action to be taken, whether the member is subject to any restriction.

The rules also provide that no board or committee member may vote or participate in deliberations on any significant action if the member knowingly has a direct and substantial financial interest in the result of the vote based upon positions maintained at the Exchange or elsewhere that could reasonably be expected to be affected by the action.

Prior to consideration of any matter, each member, unless the member chooses to abstain from the deliberations and voting, must disclose to the CEO information regarding the member's positions, wherever maintained, that the Exchange reasonably expects could be affected by the significant action. The CEO will then determine, based upon the information available and the action to be taken, whether the member is subject to any restriction. A restricted member is permitted to participate in deliberations if, in the judgment of the deliberating body, the member's participation would be in the public interest and if the member recuses him or herself from voting.

B. Composition of the Board of Directors

Prior to the commencement of trading, U.S. Futures Exchange expects to have twelve members on its board. The Exchange has represented that the overall composition of the board will be balanced in that it will represent all segments of participants in U.S. Futures Exchange's activities, including brokers, arbitrage firms, institutional investors, and independent clearing entities. Thus, U.S. Futures Exchange will also comply with the Core Principle Sixteen requirement that a mutually-owned exchange ensure that the composition of the governing board reflects market participants. The majority of U.S. Futures Exchange's directors will either be U.S. citizens or persons located in the U.S. Six directors will be drawn from the members of the Exchange. The six remaining directors could include officials, employees, or members of the boards of the Exchange's parent companies. A quorum of the board will consist of 50% or more of the members of the entire board, while a majority will be at least 51% of those present and participating. Thus, if the board comprises twelve directors, seven directors will constitute a quorum and seven directors will constitute a majority if all members are present and participating. For an explanation of how the board will be selected, please refer to the response to Rep. Burns's request for information on who elects the board set forth below.

C. Executives of U.S. Futures Exchange

Initially, the executive officers of U.S. Futures Exchange will be the President, who will also serve as the CEO of the Exchange, the Chief Financial Officer ("CFO"), and the General Counsel, who will also head the exchange's compliance department.

The President, in his capacity as CEO, will have general charge of the business, affairs and property of the Exchange and control over its officers, agents and employees, subject to the direction of the board. Generally, the President/CEO will have the authority to: (1) hire and dismiss employees and to establish their qualifications, duties and compensation; (2) execute and deliver contracts, instruments, and other documents on behalf of the Exchange; and (3) perform other duties as assigned by the board. The President/CEO will also appoint officers or employees to be members of the appeals committee, which will hear appeals from denials of membership applications and from decisions of the disciplinary committee, and will be vested with authority to take action in the event that an emergency situation arises. The board also has the power to appoint such other officers as it deems fit.

The CFO will have custody of the Exchange's funds and securities, will keep full and accurate accounts of all receipts and disbursements in the books and records of the Exchange, and will deposit all monies and other valuable effects in the name and to the credit of the Exchange.

The General Counsel, in addition to serving as Chief of the Compliance Department, will perform such other duties as assigned by the board or delegated by the President/CEO.

D. U.S. Futures Exchange's governance structure in comparison to the governance structures of other U.S. designated contract markets

It should be noted that the governance structures that are in place among current U.S. designated contract markets are not the same across the board. However, they each comply with the governance core principles detailed above. Further, because U.S. Futures Exchange is a start-up exchange, which has not yet traded a single contract, an apples-to-apples comparison of U.S. Futures Exchange to the other exchanges is not appropriate. U.S. Futures Exchange's governance structure will nevertheless be comparable to the governance structures that are in place at other U.S. designated contract markets in that it will consist of an at least twelve-person board of directors and will have three executive officers that will be responsible for the core functions of the exchange.

In response to Rep. Burns's request during the hearing for more information on who the shareholders of U.S. Futures Exchange are, who elects the board, and what role they will play, the following information is supplied for the record.

According to its application and supporting materials, U.S. Futures Exchange is a Delaware limited liability company, which is wholly owned by U.S. Exchange Holdings, Inc. ("U.S. Exchange Holdings"), a Delaware corporation. U.S. Exchange Holdings is a wholly owned subsidiary of Eurex Frankfurt A.G., ("Eurex Frankfurt"), which also owns the German exchange, Eurex Deutschland. Eurex Frankfurt, in turn, is a wholly owned subsidiary of Eurex Zürich A.G. ("Eurex Zürich"), which is owned in equal parts by Deutsche Börse A.G. ("Deutsche Börse") and SWX Swiss Exchange. Deutsche Börse is a publicly traded company with approximately 36,000 shareholders. The majority of Deutsche Börse shares are held by U.S. and U.K. investors. The largest shareholder is a U.S. fund manager. SWX Swiss Exchange is wholly owned by SWX Group, which is wholly owned by the 54-member Verein SWX Swiss Exchange. An organizational chart showing the ownership structure of U.S. Futures Exchange and its affiliated companies is attached as Exhibit A.

U.S. Futures Exchange's board of directors will be selected by the board members of U.S. Holdings, who are also members of the Eurex Frankfurt and Eurex Zürich executive committees, at a meeting of the shareholders. U.S. Futures Exchange has indicated that, in selecting its board, the board of U.S. Exchange Holdings will likely consult with its shareholder, Eurex Frankfurt, which in turn may consult with its parent companies. As outlined above, the day-to-day operations of U.S. Futures Exchange will be overseen by the President/CEO of the Exchange, the CFO, and the General Counsel, subject to the direction of the board.

The Commission understands, as U.S. Futures Exchange testified at the Committee's hearing in November, that Eurex Frankfurt may sell a minority equity interest in U.S. Futures Exchange to one or more U.S. market participants. In addition, we note that there have been articles in the trade press since the beginning of 2003, which have discussed this possibility. Recent articles, citing a senior inside source, have suggested that BrokerTec Futures Exchange may be considering a transaction involving U.S. Futures Exchange, in which the shareholders of BrokerTec Futures Exchange may take a minority equity interest in U.S. Futures Exchange. The

Commission understands that the shareholders of BrokerTec Futures Exchange do have an interest in such a transaction, although no such transaction has been consummated to date. BrokerTec Futures Exchange is a CFTC-designated contract market that is owned by a number of major U.S. and global financial institutions.

The sale of an equity interest in U.S. Futures Exchange to a market participant or a group of market participants may include the right to nominate directors to serve on the board and/or vote on their selection. The Commission expects that if a change in share ownership is concluded prior to approval of the application that the Exchange will supplement the application with all relevant information. If a change in ownership is concluded after approval of the application, the Exchange could certify to the Commission that it continues to comply the Act and regulations, as was done recently by LIFFE in acquiring 100% ownership of NQLX, a U.S. DCM that began as a joint venture between LIFFE and NASDAQ.

In response to requests from Reps. Boehner, Hill, and Neugebauer during the hearing for an explanation of the "call around" market, the following information is supplied for the record.

The Commission understands that the term "call around market" refers to an over-the-counter (OTC) market in options on futures. This term is used in Europe. In the "call around market" a customer or broker typically "calls around" to obtain quotes from several different market makers in order to find the best deal. It has been explained to Commission staff that the electronic options market in Europe has developed in this way primarily because existing electronic trading systems do not have the functionality to handle the vast majority of the complex strategies that option traders often employ. In this regard, the Eurex Deutschland trading system currently recognizes only seven, simple two-legged types of option strategies. Because of the limited capabilities of existing electronic trading systems in Europe, traders who wish to effect complex option trades must do so off-exchange.

In Germany, once an OTC transaction in options is made, it is booked on Eurex Deutschland as a block trade and is then cleared by Eurex Clearing, A.G. ("Eurex Clearing"), the clearing and settlement arm of Eurex Deutschland. Eurex Deutschland has set a minimum block trade threshold of fifty contracts to facilitate the transfer of these complex option trades for clearing.

In discussions with Commission staff, U.S. Futures Exchange officials have stated that it is very unlikely that a variant of the European "call around market" would be replicated in the U.S. In its application, the Exchange is proposing certain measures that should facilitate option trading being executed on its trading system and discourage off-exchange trades. First, U.S. Futures Exchange will introduce a new options strategy board that will accommodate forty-five predetermined types of option and option/futures strategies (compared to the seven strategies available on the Eurex Deutschland and the a/c/e platform used by the Chicago Board of Trade for the past several years). This should make it easier to execute complex trades on the central marketplace and lessen the need for personal contacts to negotiate customized terms. Second, U.S. Futures Exchange has indicated that it plans to set the minimum block trade threshold at 2,500 contracts for the U.S. Treasury contracts it is likely to introduce first. This is fifty-times

greater than the fifty-contract minimum set by Eurex Deutschland for its German government debt contracts. Third, U.S. Futures Exchange proposes to have permanent market makers, which should facilitate the matching of traders wishing to execute complex option trades.

However, even if some option trades were executed in the OTC market and then booked on U.S. Futures Exchange via its block trading facility, this would not necessarily have negative consequences. Although this type of activity has been criticized as lacking transparency, Commission staff have been informed that the bid/ask spread in the well-developed German "call around market" generally is tighter than the bid/ask spread on the Eurex Deutschland trading system. Such block trading activity on a U.S. market would be subject to appropriate record keeping requirements, and has been allowed in the U.S. since 2000. Furthermore, any such off-exchange execution of U.S. Futures Exchange transactions would be analogous to other off-exchange trading that is permitted by the Act, including the exchange of futures for physicals, which has been allowed in the U.S. for decades. Finally, we highlight that the Commodity Futures Modernization Act of 2000 ("CFMA") expressly provided for the clearing of OTC trades by a CFTC-registered derivatives clearing organization. An arrangement that would permit OTC transactions to be booked through U.S. Futures Exchange's block trading facility and then cleared, could be similar to the clearing done by the New York Mercantile Exchange ("NYMEX") clearing house of certain OTC energy market contracts that are executed in the OTC market. Under that arrangement, which received Commission approval in May 2002, trades based on contract terms set by NYMEX are executed in the OTC market and then transferred to NYMEX for clearing.

Questions from Representative Peterson submitted to the Commission following the hearing

You note in your letter to Chairman Goodlatte that the Commission is aware of areas where Eurex US has announced business plans that are not included as part of their application. The Chicago Exchanges will testify here that by having these business plans but not including them in application materials, Eurex US has submitted an incomplete application.

An example given of this incompleteness is the intent of Eurex U.S. to establish a Clearing Link between the U.S. exchange and Eurex Frankfurt. Wouldn't such a plan be an important consideration in judging the validity of the application?

As previously stated, neither the Act nor Commission regulations require that an application for designation as a contract market include all future clearing plans that may be contemplated, or future plans in general. An application need only include information demonstrating an ability to satisfy the conditions for designation (eight designation criteria and eighteen core principles) based upon a current business plan. The U.S. Futures Exchange application requests approval based upon a services agreement between U.S. Futures Exchange and The Clearing Corporation ("CCorp"), a Commission registered derivatives clearing organization ("DCO") based in Chicago, which calls for all transactions executed on the Exchange to be cleared by CCorp. The Commission's review of the clearing component of the application has thus been proceeding on the basis of that agreement.

Although U.S. Futures Exchange had publicly announced at the time of the hearing its intent to offer a cross-border clearing link at some point in the future, in its testimony at the hearing it affirmed that all transactions executed on the Exchange would be cleared by CCorp. In a letter to the Commission dated November 18, 2003, the Exchange stated that the technical and legal relationships that would need to be in place between CCorp and Eurex Clearing relating to the contemplated link required further study and consultation with the clearing members of those organizations and their customers.

The Commission's view has been, and is, that no purpose would be served by delaying the review of an application for designation simply because the applicant has announced that it intends to expand the services it will offer at some point in the future. While an applicant's inchoate plans—which may or may not eventually come to fruition—may be of general interest to both the Commission and the public, they are not relevant to the Commission's analysis with respect to an applicant's present ability to satisfy the conditions for designation based on the arrangements contained in the application. The Commission has also been concerned that a requirement that applicants submit inchoate business plans, which may or may not ever be finalized, could result in an unnecessary waste of Commission resources. Exchanges, like all businesses, are continually reassessing and adjusting their business plans to meet competition and to expand. The Commission has never required an exchange to reveal all of its future plans, which may be at various stages of development and indeed may never be adopted, when considering whether a specific proposal at hand complies with the Act and the Commission's regulations.

In a press release issued on December 16, 2003, however, CCorp and Eurex Clearing announced that they have finalized the details of a "Global Clearing Link" that would "give customers choice of clearing access through Eurex Clearing and CCorp for US Dollar and Euro-demoninated products traded on Eurex US and on Eurex in Europe," which will be launched on March 28, 2004, "[f]ollowing consultation with both customers and regulators." Given this announcement, the Commission is currently evaluating whether the anticipated link has been finalized to the point that it should be made a part of U.S. Futures Exchange's application for designation.

In your letter to Chairman Goodlatte, you suggest that Eurex Frankfurt's clearing entity would need to receive a US designation for such a plan to work, but Eurex US will testify that is not necessarily so, depending on how the link is structured. What do you know about the planned clearing link and what consideration has the Commission given to the suggestion that this is a material omission?

Sections 5(b)(5) and 5(d)(11) of the Act require that transactions executed on a U.S. DCM be cleared by a U.S. registered DCO. Thus, a clearing link that would permit transactions executed on U.S. Futures Exchange to be cleared by Eurex Clearing would require that Eurex Clearing first be registered with the Commission as a DCO. However, there are other types of cooperative cross-border arrangements among exchanges and clearing houses that do not involve the clearing, as defined in the Act, of transactions executed on a U.S. DCM by a foreign entity and thus would not require that the foreign entity be registered as a DCO with the Commission.

An example is the mutual offset agreement between the Chicago Mercantile Exchange and the Singapore Exchange, Ltd.

Although Commission staff have had discussions with staff of U.S. Futures Exchange and CCorp about their concept for a link, no filing has been made with the Commission. Commission staff are working to develop an understanding of the proposed mechanics of the concept and to identify all regulatory issues. In press reports published on December 17, 2003, Rudolph Ferscha, the CEO of Eurex Deutschland, and Dennis Dutterer, the President and CEO of CCorp, were quoted as stating their views that the clearing link would not require Commission approval. The Commission's Division of Clearing and Intermediary Oversight staff are not at all persuaded, however, based upon what they know about the concept so far, that a DCO designation is not necessary. As stated above, the Commission is evaluating whether the anticipated link has been finalized to the point that it should be formally submitted to the Commission for review.

It seems to be fairly well-known that Eurex US intends to list futures contracts on U.S. Treasury securities. However, the terms and conditions of these contracts are not included in the Eurex US submission. Wouldn't it be helpful to the Commission in its review of the application to have the terms of trading – especially in an instance where the applicant has such a clear idea of its plans?

U.S. Futures Exchange has submitted to the Commission the draft specifications for the futures and options contracts involving U.S. Government securities that it intends to list for trading. The Commission provided copies of the draft contracts and the Exchange's application for designation to both the Board of Governors of the Federal Reserve System and the Department of the Treasury on November 5, 2003. They have until December 22, 2003 to forward their comments to the Commission. The Commission will consider any comments received and will make them part of the public record.

A Commodity Exchange Act criteria for designation requires that the applicant: "provide the public with access to the rules, regulations, and contract specifications" of the exchange. Under the terms of that criteria, can the application be approved if no public access has been provided?

Under Designation Criterion Seven, an applicant must demonstrate that it will provide the public with access to the rules, regulations, and contract specifications of the exchange. Core Principle Seven requires an exchange to make public the terms and conditions of the contracts listed on the exchange, and the mechanisms for executing transactions through the exchange's facilities. Compliance with these transparency requirements is mandated for contract markets only after they have been designated by the Commission and are actually listing contracts for trading. In determining the sufficiency of a contract market application, the Commission demands that the applicant demonstrate an ability to comply with all applicable conditions for designation. With respect to Designation Criterion Seven and Core Principle Seven, U.S. Futures Exchange has committed in its application that, once designated, it will post on its website its bylaws, rules and contract specifications, including the terms and conditions of all contracts and the mechanisms for executing transactions on or through the Exchange's trading

system. In the past, the Commission has found similar representations to be a sufficient demonstration of an applicant's ability to comply with those provisions.

Witnesses today will testify that the CFTC should suspend consideration of the Eurex US application until more details are provided. Under what conditions, in general, would the Commission consider issuing such a suspension?

Pursuant to Section 6 of the Act, the Commission must approve or deny an application for designation as a contract market within 180 days of its filing, unless the Commission determines that the application is "materially incomplete," in which case it may suspend the running of the 180-day period. Section 6 vests the Commission with the authority and discretion to determine whether an application is materially incomplete. Recently, for example, Commission staff determined that an application was materially incomplete for failing to, among other things, describe with sufficient specificity procedures for conducting appropriate, thorough, and timely investigative analysis in satisfaction of its obligation to monitor and enforce compliance with exchange rules. Generally speaking, however, to be considered complete an application must contain: (1) a copy of the applicant's rules and any technical manuals or guides; (2) descriptions of the trading system, test procedures and results, and contingency or disaster recovery plans; (3) descriptions of the applicant's legal status and governance structure; (4) copies of agreements, including third party regulatory service agreements, that will enable the applicant to meet the conditions for designation (thus, if transactions will be cleared, the applicant must submit all applicable clearing agreements to demonstrate compliance with Sections 5(b)(5) and 5(d)(11) of the Act, which require that such clearing be done by a U.S. registered DCO); and (5) to the extent the application raises issues that are novel, or for which compliance with a condition of designation is not self-evident, an explanation as to how the application satisfies the conditions for designation.

Interested parties have urged the Commission to suspend its review of U.S. Futures Exchange's application until the Treasury contract specifications and plans for a clearing link are submitted for review. As noted above, draft Treasury contract specifications have been submitted to the Commission, the Treasury Department and the Federal Reserve Board for review. And, as also explained above, the Commission is currently evaluating whether the announced plans for a clearing link require an amendment of the application.

Eurex compliance and surveillance functions will be performed under a regulatory services agreement with the National Futures Association (NFA). Does the CFTC know how the NFA intends to carry out the compliance functions for Eurex US?

Yes. The Commission understands that NFA will use its Trade Practice and Market Surveillance (TPMS) program to carry out compliance functions for U.S. Futures Exchange. The Commission is extremely familiar with TPMS. In fact, Commission staff has reviewed the TPMS program for not only the U.S. Futures Exchange application, but also in connection with four previous contract market applications—BrokerTec Futures Exchange (BTEX), Inet Futures Exchange (formerly the Island Futures Exchange), Merchants' Exchange, and OnExchange Board of Trade, Inc. In addition, the Commission's Division of Market Oversight recently completed a review of TPMS in its rule enforcement review of BTEX 's trade practice and

market surveillance programs. On each of those occasions, staff found that the TPMS program performed satisfactorily.

Generally, NFA, subject to U.S. Futures Exchange supervision, will use its TPMS program to monitor trading to prevent manipulations, price distortions and disruptions of the delivery or cash settlement process. 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 TPMS program also utilizes a sophisticated automated system to detect potential trade practice violations such as trading ahead, front running, wash trading and other abusive practices.

Has NFA ever assumed the responsibility for regulation to the same degree as contemplated in this Eurex US application?

If approved, U.S. Futures Exchange will be the fifth start-up exchange for which NFA has handled regulatory services. As with any start-up exchange, it is difficult to estimate what initial trading volume will be and whether, or at what rate, it will increase over time. Commission staff preliminarily believe, however, that the level of human and technical resources NFA would use for handling regulatory services for the Exchange during the initial stages of trading will be adequate, and that NFA has the ability to promptly increase those levels should it become necessary.

Commission staff understand that, initially, NFA will assign five TPMS staff members to handle regulatory services for the Exchange. NFA has represented that, if needed, it will hire and train an appropriate number of new staff. NFA could increase its TPMS staffing level on an even quicker turnaround by utilizing a number of additional employees who have already been cross-trained, as well as by drawing upon a pool of 90 Compliance Department employees. NFA's contract with U.S. Futures Exchange includes volume-based payments to NFA to fund all of these measures.

It should be emphasized that U.S. Futures Exchange will be an exclusively automated exchange, and NFA's TPMS program, while it certainly utilizes human resources, strongly relies on automation to detect violative conduct. This heavy usage of an automated system will make it much easier for both the Exchange and NFA to respond quickly to increased volume by scaling their existing technical systems, and will reduce the need to hire and train new personnel. As with all other instances in which an exchange outsources self-regulatory responsibilities, the Commission will monitor the adequacy of the services provided, as it does when exchanges themselves perform these functions.

The CBOT identifies Commission Regulation 1.59 as prohibiting employees and officials of a US contract market from trading on the basis of inside information on a linked exchange. Are you concerned that the same regulation does not apply to off-shore exchange officers and employees?

Section 9(f) of the Act and Commission Rule 1.59 prohibit employees, governing board members, committee members or consultants of a board of trade, exchange, or registered futures

association from trading on or disclosing material, nonpublic information obtained through special access related to the performance of their duties at the exchange. The prohibition extends to any person who knowingly obtains such information in violation of Section 9(f) and Rule 1.59. The Commission can investigate and prosecute such violations in the same way that it can investigate and prosecute any other violation of the Act or the regulations as detailed above.

Section 9(f) and Rule 1.59 arguably do not apply where an exchange holding company or any other person lawfully obtains material, nonpublic information about trading on an exchange, such as when a holding company is performing certain surveillance functions for the exchange. This situation could occur whether the holding company of an exchange is located in the U.S. or abroad.

To address this issue in a way that is comparable to other U.S. Exchanges, U.S. Futures Exchange promulgated Rule 207, which prohibits officers and employees of the Exchange from trading on the Exchange or in any related contracts, and also bars board members, officers, and employees of any of the Exchange's corporate affiliates from improperly using or disclosing material, nonpublic information obtained through the performance of their duties for the Exchange. In addition, any employee of a U.S. Futures Exchange affiliate that provides regulatory services will consent to Commission's jurisdiction with respect to the insider trading prohibition, and U.S. Futures Exchange will act as such employees' agent for service of process and the receipt of any communications from the Commission for this purpose. This approach is substantially similar to that employed by the Chicago Board of Trade when it entered into an agreement with Eurex Frankfurt in 2000 in connection with their a/c/e joint venture.

Questions from Representative Boehner

Chairman Newsome would an international trading or clearing link similar to that which Eurex U.S. has outlined as part of its business model, make manipulative activity harder to detect?

If U.S. Futures Exchange submits a trading or clearing link to the Commission, the Commission will carefully review it to determine whether, and to what extent, it may create an opportunity for manipulative activity to occur. Detecting and deterring manipulation is core to the Commission's mission, and we would be equally concerned about any such possibility. The Commission would not approve any trading or clearing link unless it was satisfied that adequate safeguards against manipulation were in place.

In the wake of recent high-profile corporate governance failures, the Securities Exchange Commission (SEC) has listed improving corporate governance as one of its top priorities. Has the CFTC reviewed the corporate structure and membership profile of Eurex U.S.? Will board members be compensated and if so in what form?

Commission staff have reviewed the Exchange's corporate and governance structures and the requirements for membership. Details of the corporate and governance structures are set forth above in responses to requests for information from Reps. Stenholm and Burns. Pursuant to Section 5.5 of the Exchange's bylaws, each director will receive compensation for services

rendered as a director of the Exchange. That compensation will be paid as an annual stipend and/or on a per-meeting basis, as determined by the board.

U.S. Futures Exchange is not a member-owned entity; thus, membership on the Exchange confers no ownership rights or privileges. Membership is defined by U.S. Futures Exchange rules as the provision of access to the trading system granted by the Exchange for the purpose of effecting transactions. A member is any person (defined as an individual, corporation, company, limited liability company, partnership, limited liability partnership, or other entity), authorized by the Exchange (or otherwise) to trade on the trading system. A member must be a clearing member or have an agreement with a clearing member to guarantee and clear transactions of the member or the member's customers. A clearing member is an Exchange member that is also a member of the clearing organization authorized to clear and settle transactions executed on the trading system and that has clearance and settlement privileges under the bylaws and rules of the clearing organization.

In addition, members that are individuals must be adults of good character. Members that are entities must be duly organized, existing and in good standing under the laws of the jurisdiction in which they are organized. An applicant for membership must have good commercial standing and appropriate business experience, adequate financial resources, and operational capabilities for the type and level of business it intends to conduct. Where relevant, an applicant for membership shall be licensed, registered or otherwise permitted by the appropriate governmental authority to conduct business on the Exchange, and meet any other criteria it prescribes. An applicant may be denied membership if, among other similar reasons, the applicant: (1) has been convicted of any felony or misdemeanor involving the purchase or sale of commodities, futures, options, securities, or other financial instruments, or involving moral turpitude; (2) has been sanctioned or censured by any governmental agency; or (3) has been suspended or disciplined by any self-regulatory organization. Thereafter, a member must abide by the U.S. Futures Exchange bylaws and rules, as well as the provisions of the Act and Commission regulations. A member must file reports with the Exchange disclosing events that reflect on his or her suitability to continue as a member, including reports of disciplinary actions by governmental or self-regulatory entities. Although we cannot say for certain at this time, we anticipate that the membership will be broad-based and representative of all segments of the industry.

Although Eurex U.S. has stated that the National Futures Association (NFA) will perform surveillance for trade practice violations and for market manipulations, the U.S. Futures Exchange will conduct its own market supervision which will include market supervision through a general services agreement with Eurex. Does this general services agreement comply with the Commodity Exchange Act which prohibits the outsourcing of compliance functions to a foreign entity that is not registered with the CFTC?

Under Section 5c(b) of the Act, a contract market "may comply with any applicable core principle through delegation of any relevant function to a registered futures association or another registered entity." In applying this provision, the Commission has always distinguished between "delegating" and "contracting out," and has made clear that, while contract markets may "delegate" core principle functions only to registered entities, that limitation does not apply to

contractual outsourcing arrangements. In adopting rules implementing the Commodity Futures Modernization Act of 2000, the Commission explained that it had long recognized the ability of contract markets to meet self-regulatory obligations by using persons under contract to perform specified duties, so long as the exchange ensured that it maintained a sufficient degree of control over the persons under contract and that such persons had no conflict of interest. *See* 66 Fed. Reg. 42256, 42266 (Aug. 10, 2001). By contrast, a delegation confers upon another the authority to act in the delegating entity's name. The Commission observed that, "the distinction between delegation of authority and contracting for services is particularly well-illustrated in matters related to member discipline and market surveillance. A market that delegates these functions empowers the delegate to take appropriate remedial actions, including the sanctioning of members or market participants for rule violations. In contrast, a market may contract with an entity to conduct trading surveillance and to investigate the facts surrounding alleged rule infractions. Unlike a delegatee, a contractor would not have the authority to decide on behalf of the delegating entity whether an infraction had occurred or to impose remedial sanctions. These decisional functions can be exercised only by [the Exchange itself, or by] delegation of that authority to registered entities or a registered futures association, as Congress has provided." *Id.*

The Commission understands that U.S. Futures Exchange intends to have Eurex Frankfurt provide market supervision services to the Exchange on a backup basis in the event that the regular Exchange market supervision staff based in Chicago are unable to conduct operations. (Market supervision responsibilities are, essentially, the administration of the trading platform and include opening and closing markets, handling trading halts due to volatility interruptions, resolving mistrades, switching from normal to fast markets and back, and maintaining the proper operation of the trading system.) Eurex Frankfurt would provide these services pursuant to a contractual agreement under which U.S. Futures Exchange would maintain supervisory authority over Eurex Frankfurt at all times. Commission staff preliminarily believe that, in light of this retention of supervisory authority, U.S. Futures Exchange would be "contracting out" rather than delegating market supervision responsibilities to Eurex Frankfurt. In that case, the Act's limitation on delegations would not apply.

Notably, contracting out core principle functions to a non-registered entity is not at all unusual. In fact, on at least two occasions, contract markets have contracted out to foreign non-registered entities in circumstances very similar to those contemplated by the U.S. Futures Exchange application. For example, the Chicago Board of Trade used Eurex Frankfurt personnel for primary market supervision duties during the early stages of trading on the a/c/e platform, and the London International Financial Futures and Options Exchange currently performs comparable functions for the NQLX Futures Exchange.

Questions from Representative Gutnecht

What ability does the CFTC have to assert its jurisdiction over the European parent company of Eurex U.S. and its officials? Does the CFTC have the authority to conduct on-site inspections of that company and its officials in Europe?

As set forth above in response to Rep. Pomeroy's request for information on the Commission's ability to protect the U.S. public interest when the entity in question is foreign-

owned, and the response to Rep. Peterson's concerns regarding insider trading prohibitions, the Commission has comprehensive powers to investigate and prosecute violations of the Act, Commission regulations, and Commission orders. This authority reaches beyond the territorial limits of the United States to wherever persons or information may be located. The combination of the tools available to the Commission under the Act, the regulations, other provisions of Federal law, the cross-border information sharing arrangements between the Commission and the BaFin, and the Exchange's own restrictions on the use of insider information, should be adequate to address any regulatory concerns that may arise with respect to U.S. Future's Exchanges European affiliates.

Will Eurex be required to identify individuals in the European parent company that will operate, oversee and have access to information regarding the daily operations of Eurex U.S.?

Whether a parent company is foreign or domestic, neither the Act nor the Commission's regulations require an exchange to identify the individuals within a parent company who may have some responsibility for the activities of the exchange. As described in detail above, however, should the activities of an individual in a parent company violate the Act, Commission regulations, or a Commission order, or cause an exchange to violate the Act, Commission regulations, or a Commission order, or should they give rise to the threat of manipulative or disruptive activity, the enforcement tools available to the Commission should be sufficient to address the situation, whatever the case may be.

What role will the European Parent company play in the operation of Eurex U.S.?

The corporate parent affiliates of Eurex U.S. will provide assistance to U.S. Futures Exchange by performing, under contract, certain non-regulatory support functions. U.S. Futures Exchange has contracted with Eurex Frankfurt to provide certain software development, preventive and corrective maintenance, and network operations services relating to the trading platform. Eurex Frankfurt will also provide certain accounting and corporate services including, among other things, human resources, corporate communications, including support of marketing communications and support of events, and office infrastructure, including support of facility management, office automation, and administration of resources. In addition, Eurex Frankfurt will provide, upon request of U.S. Futures Exchange, a back-up capability for market supervision. The Exchange plans to have Deutsche Börse handle marketing and distribution of Exchange market data.

In addition, as described above, prior to the launch of trading, U.S. Futures Exchange plans to expand membership on its board of directors from one to twelve. The Exchange has represented that six of the directors may be drawn from officials, employees, or members of the boards of the Exchange's parent companies.

Has the CFTC ever approved a similar program whereby an exchange offers to share significant exchange revenues with market participants if they trade more than other market participants or brokering more customer orders than other brokers?

Historically, incentive programs have been used by futures exchanges to encourage market participation in specified new or low volume contracts. Neither the Act, nor the Commission's regulations prevent exchanges from adopting incentive programs. Futures exchanges have consistently offered reduced fees and other economic incentives, such as "fee holidays," for market makers, brokers and traders in order to attract volume to particular products. Such incentive programs may be offered by an exchange pursuant to Commission approval, or by certifying to the Commission that the program complies with the Act and regulations.

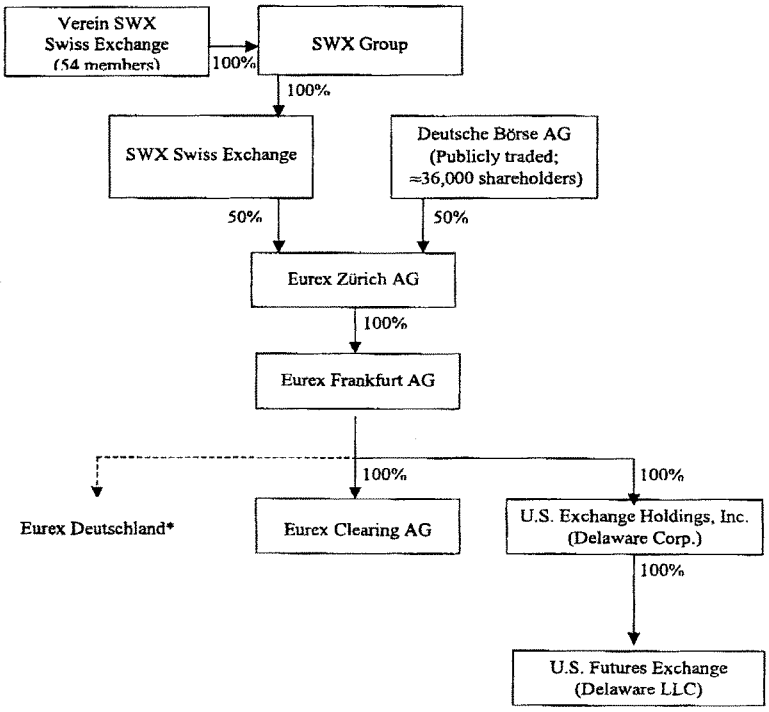
The Commission has accepted at least three incentive programs under which an exchange has shared revenues with certain market participants. For example, in February 2003, NYMEX certified an incentive program for transactions executed on the exchange's new electronic trading platform. The plan called for 50% of gross revenues generated from trading on the platform to be pooled and then allocated on a prorated basis to intermediaries responsible for bringing a minimum of 10,000 contracts per month to the trading platform. In April 1999, the CME adopted an incentive program for Euro FX and Euro FX Cross-Rate futures and option contracts. The incentive program required the CME to contribute cash to a "bonus pool" in amounts tied to pre-set trading volume levels. Aggregated funds would then be disbursed to product locals and executing firms based upon each market participant's contribution to overall trading volume. In March 2000, the CME also adopted an Agency Note Futures Incentive Program that allowed market participants who brought substantial order flow and acted as market makers during the contract's initial development to share in the net revenues generated from Agency trading.

In other programs the CFTC may have approved, how did the CFTC or the exchange ensure customer protection or prevent market abuses? Does this constitute a conflict for trading firms?

Commission staff's regulatory analysis of exchange sponsored incentive programs focuses on a program's manner of implementation and the potential for distorting open, competitive, and efficient trading through facilitating illegal trading practices. Commission staff review incentive programs with a view to determining whether such programs are structured in a way so as to encourage trade practice abuses, such as wash or fictitious trading. Commission staff will accept incentive programs only if they are assured of an exchange's ability to monitor and detect trade practice violations, and maintain a competitive and an efficient marketplace.

Commission staff would also analyze an incentive plan's potential for eroding fiduciary obligations owed by futures brokers to customers. Core principle twelve requires that designated contract markets establish and enforce rules that protect market participants from abusive trading practices committed by any party acting as an agent for a participant. In a situation where a broker handles an order that could be executed at more than one exchange, the Commission would want to ensure that an incentive plan does not compromise the broker's fiduciary obligations.

CORPORATE PROFILE OF U.S. FUTURES EXCHANGE'S OWNERSHIP AND AFFILIATED COMPANIES



* Eurex Deutschland is a company under German public law. Its operations are provided 100% by Eurex Frankfurth AG.

STATEMENT OF CHARLES P. CAREY

Mr. Chairman and members of the committee, I am Charlie Carey, the chairman of the Chicago Board of Trade. I am pleased to appear before this committee to discuss our concerns about the application filed by Eurex U.S. to become a registered futures exchange, what the statute calls a designated contract market.

Mr. Chairman, the Board of Trade commends you for your leadership in calling this hearing. The issues raised by the Eurex application are profound and far-reaching. This hearing will promote a serious public debate on those issues.

To give that debate a proper framework, the committee should be aware of a number of basic facts at the outset. First, Eurex would have you believe that its new exchange would bring electronic trading to the U.S. The truth is that the Board of Trade, along with other U.S. exchanges, now offers vibrant and liquid electronic trading markets. For us, over 80 percent of our popular U.S. Treasury Futures complex futures contracts are executed electronically. Our electronic trading markets are growing rapidly every day. And we hope to increase that growth starting next year once we replace the trading system offered by Eurex with what the industry recognizes and we believe to be a more attractive, technologically sophisticated trading platform offered by Euronext-Liffe. At the same time and recognizing the current limitations of technology, we continue to—offer our customers the opportunity to execute futures and options transactions in our trading pits in order to provide an open and transparent marketplace for all orders regardless of complexity— At the CBOT we continue to make the necessary investments in both trading platforms to give our customers a choice of two markets that provide integrity, fairness and transparency.

Second, Eurex claims the CBOT is a monopoly. Not true. As even Eurex's counsel has conceded to the CFTC, that "there is vigorous competition between U.S. exchanges is beyond dispute." The Board of Trade competes daily for interest rate derivatives and risk management business with some of the best capitalized firms in the world. Some of those entities also own an existing U.S. exchange that competes directly with the Board of Trade by cloning its products in an electronic trading market.

Third, Eurex would have you believe that it will become the low-cost provider of trading services in the U.S. Not true. Liquidity is the key for any trader. Participants come to the CBOT's centralized pool of liquidity to assess the market and determine the best price, based on bids and offers that are posted for all to see— That kind of clear market transparency makes price discovery faster and more efficient. Cost is a function of the bid-ask spread, the time to execute a transaction and the exchange transaction fees— CBOT remains the leader and offers the best value for market participants in terms of market transparency and liquidity.

Finally, Eurex would have you believe that it will offer a fully electronic marketplace. That is more ruse than reality. The fact is that the Eurex trading software is not capable of accommodating liquid and transparent options trading, complex futures trading or combination orders involving both futures and options. These types of orders are prevalent in the U.S. Treasury markets. That is one of the reasons we choose what we thought was a more technologically sophisticated alternative in the trading system developed by Euronext-Liffe. Instead, Eurex will rely upon a call-around telephone dealer market for options and other complex trading, one that allows dealers to quote opaque prices to customers and to internalize order flow. Then the Eurex system will be used just to record the trade. That is not the kind of open and competitive market transparency the Board of Trade offers through both its trading pits and electronic trading systems. We believe the more market transparency the better price the customer receives. (As this committee will recall, the energy market pricing difficulties of a few years ago confirm the public interest in and value of market transparency.) Those are business considerations; this hearing has been called to discuss the regulatory implications of the Eurex U.S. application. We have three essential points about the application.

- It should be considered fully and carefully by the Commodity Futures Trading Commission.
- It should be considered only when the application is complete; right now it is not.
- It should be granted only if the application meets the statute's specific criteria for registration of an exchange.

The application review process should be thorough. The Eurex application is too important and raises too many novel issues for consideration under any form of quick fix process. I am pleased the CFTC has agreed and decided to disallow fast track treatment of the application. Allowing a foreign board of trade to own and operate a U.S. exchange as a subsidiary is only one of many challenging issues the

Eurex business plan presents. Some of those issues go directly to preventing manipulation, protecting customers, providing financial integrity and promoting market transparency. We know that the CFTC is as concerned about these public policy goals as we are. We agree with the CFTC that the public interest compels the agency to be as informed and deliberative as they can be when addressing those types of considerations in the context of designating a contract market.

The application must be complete and accurate. The CFTC should have the opportunity to consider the real business plan Eurex proposes to adopt. Eurex's application, however, is very different from the business plan Eurex portrays in their press statements, website and marketing materials. Just like a consumer should not be subject to bait and switch sales tactics, the CFTC should not be asked to approve one business model while the applicant is touting a different business plan it intends to implement once the CFTC process runs its course. The CFTC should consider the application only when it is complete and accurate.

The application should be approved if it meets the high statutory standards for a new contract market. We have no quarrel with the CFTC's rules or the statute's terms governing the process for CFTC consideration of contract market designation applications. The decision whether to grant contract market status to any applicant is among the most significant decisions the Commission is called upon to make, especially since Congress has recognized that "effective self-regulation" is what allows our markets to serve the "national public interest." That decision should be based on the merits of all aspects of the application and the CFTC's informed judgment whether the application satisfies the statute.

Here is the background that leads me to these conclusions.

On September 16, 2003, Eurex U.S. filed its contract market designation application with the CFTC. Eurex U.S. is a subsidiary of Eurex Frankfurt and an affiliate of Eurex Deutschland, the only futures and options exchange in Germany. The application consisted of 20 parts, 16 of which Eurex insisted were entitled to confidential treatment. While Eurex later reduced that confidentiality request to nine parts of its application, the missing parts are still the meat of the application. The Board of Trade and others have contested treating those materials as confidential under the Freedom of Information Act. That matter is still pending before the Commission and should be resolved before any further action is taken on this application.

The Commission requested public comment on those portions of the Eurex application for which Eurex has not sought confidential treatment. Comments were due on October 16. The Board of Trade submitted its comment letter to the Commission on that date and asks that a copy of that letter be included in the record of this hearing.

On October 14, the CFTC informed Eurex that its application did not qualify for fast track consideration. Instead, the application would be considered under the statutory process, which contemplates action within 180 days on any application that is materially complete. We believe that the 180 day time frame should be ample time to consider the Eurex application if it is materially complete.

In our view, however, the Eurex application is materially incomplete right now. Here is why.

The Eurex application is significant for how little it reveals and how much it conceals.

It reveals that Eurex intends to use the same electronic trading system it developed with the Board of Trade and which the Board of Trade uses now for its ever-growing electronic futures trading platform, called the a/c/e system. It reveals that Eurex will rely in some way on National Futures Association for market surveillance along with Eurex Frankfurt and Eurex Deutschland. It also reveals that Eurex will use The Clearing Corporation (formerly known as the Board of Trade Clearing Corporation), a clearing organization in which Eurex now owns a large stake. It reveals that Eurex intends to trade futures and options on futures contracts.

What does the application conceal? The list is long. Very long. We don't know if the NFA can legally conduct market surveillance for Eurex, how NFA will conduct market surveillance, what resources it will employ, what fees it would receive, what experience and jurisdiction it has in policing foreign traders in what aspires to be an international market and how it would propose to overcome any CFTC-cited shortcomings in the delegated functions it already performs for other selected and far smaller markets. We don't know how NFA, or Eurex for that matter, intends to police the over-the-counter call around market in options on futures Eurex apparently must offer as the only way it trades options.

We don't know what role Eurex Frankfurt and Eurex Deutschland will play in preventing manipulation on Eurex U.S., how they will avoid the acknowledged squeezes they have experienced in their home markets in recent years, and by what

statutory authority they can perform any delegated functions for a US designated contract market since they are not registered under U.S. law. We don't know what SRO function Eurex U.S. will actually perform, what resources and capabilities it has to do so or how it can discharge its statutory obligation to be sure its delegates will perform their statutory and contract functions as required. We don't even know the terms and conditions of the futures and options contracts that Eurex U.S. intends to trade and whether those terms and conditions will make trading more or less susceptible to manipulation.

We don't know what clearing arrangements or clearing system Eurex will actually use. We don't know how much of the trading in the US will be cleared in Germany, how the much ballyhooed Eurex-TCC global clearing link would work, how the CFTC will oversee that activity, how Eurex in Germany can legally clear trades on a U.S. contract market without becoming a CFTC-registrant, or how fairness and avoidance of conflicts of interest can be achieved for US customers and firms once the link is implemented if the German clearing entity dictates clearing practices. We don't know much about this clearing link other than that Eurex and TCC promised the world that the link would be operational on February 1, 2004 or "shortly thereafter." And that promise was specifically made to those shareholders who voted to approve the recent Eurex-TCC reorganization proposal. We don't know what risk offsets will be offered for Eurex U.S. and Eurex Deutschland contracts, who will decide on those offsets now that Eurex has become TCC's largest shareholder, or whether risk offsets will be uniform or applied in a disparate manner to attract business.

We don't know how the trading link that Eurex U.S. and Eurex Deutschland propose to establish will operate other than Eurex proposes to make trading on the two exchanges fungible. We don't know how Eurex U.S. and Eurex Deutschland can hope to offer joint trading "beginning February 1, 2004," as they claim, when the application contains none of the details of this trading link.

We don't know how Eurex will protect against non-competitive trading when it offers to pay for volume by creating significant, multi-million dollar pay-outs to traders through what is in effect a contest to become one of the top 10 traders on its markets. We don't know how Eurex would protect customers when it also offers a multi-million dollar contest prize for the top 10 brokers on its markets, creating a significant financial incentive to brokers to put orders through on Eurex even if the customer could find a better price, transparency, or liquidity somewhere else. We don't know how else Eurex is leveraging its power as the only German derivatives exchange to buy market volume and in its own words "steal liquidity" from U.S. and other exchanges.

We don't know to what extent Eurex's trading will prevent market transparency, trading that is required by law to be executed openly and competitively. We don't know how much private, off-book trading Eurex will tolerate and report belatedly on its system, falsely claiming it was executed on its market. (That's what they do for more than 90 percent of their options trading in Europe according to figures gleaned from the Eurex website because the Eurex trading software does not accommodate liquid options trading markets or complex futures trading strategies.) We don't know what spillover effect these over-the-counter, order internalization practices could have on the pricing in current markets offered by the Board of Trade and other markets. We don't even know if Eurex has any meaningful precautions in place to ensure market transparency or only is focusing on pumping up its potential volume and market share.

While we don't know the terms and conditions of any of the contracts Eurex will trade, we do know Eurex says it intends to trade U.S. Treasury Security futures, among other things. We don't know how or when Eurex intends to submit those contracts for CFTC review and, as required by law, review by the Department of the Treasury and Federal Reserve Board. We don't know what kind of self-regulatory and governmental coordination trading in these contracts would require. We don't know whether market fragmentation of current Treasury Security futures markets would lead to widening of the bid-ask spreads and increasing the cost to the Treasury of managing the national debt. This is a real cost. Prior to an active Treasury futures market at the CBOT, the bid-ask spread on Treasury bonds was around $300. Today, it is $31.25, providing substantial savings to U.S. taxpayers.

We don't know how Eurex intends to deal with a potential market emergency caused by trading in U.S. markets by foreign firms or governments, including its own. We don't know how Eurex intends to police (or the CFTC intends to police) the potential misuse of confidential trading and market surveillance data by officials at the parent company in Germany should they obtain information that employees at its subsidiary could legitimately decide to share. We don't know how the CFTC would exercise legal jurisdiction over the parent company at any time, let alone in

a market crisis. We don't know how Eurex would propose to have the CFTC coordinate with EU officials to ensure that there is no conflict of interest that could adversely affect US firms or customers.

We don't know these things because the application materials available to the public do not address these questions. Some of them may be in the application, but shielded from public scrutiny by the requested (and contested) confidential treatment request. And some of them Eurex has said one thing to the CFTC and made conflicting statements on its website and in its press statements.

On this record, we agree with the Commission's conclusion that Eurex is not entitled to fast track treatment under CFTC rules. Once complete, the application appropriately should be considered under the statutory 180 day time frame.

But the CFTC should suspend that process too for now since the Eurex application is "materially incomplete." Until Eurex provides the answers to these questions and others raised in comment letters filed with the Commission, the 180-day statutory time period should be stopped and restarted only when a complete application is on file with the CFTC. When the application is complete, we would also urge the CFTC to request further public comment on the completed application. Our comments filed on October 16 can only be viewed as an interim comment until the application is completed and finalized. We don't think we should be asked to write a book review on a book by only being allowed to read 11 of its 20 chapters.

The CFTC is a fair agency, ably led by Jim Newsome and his fellow Commissioners. We know the CFTC is dedicated to serving the public interest and the national interest. All we ask is that the CFTC make sure that they get a complete picture of the Eurex application, including fully informed public comment, and then apply the statute and regulations. The Eurex application ultimately may be approved (fully or conditionally) or denied. That is an issue for another day.

What we are most concerned about today is the process and making sure that substantial and substantive regulatory issues are considered fully with due deliberation based on a complete record. I am sure you share that objective and the CFTC does as well. I would be happy to answer any questions you might have.

STATEMENT OF MICAH S. GREEN

Good afternoon Chairman Goodlatte and members of the committee. Thank you for the opportunity to testify today on the important question of Eurex's application to become a U.S. futures exchange. My name is Micah Green. I am president of The Bond Market Association (TBMA), which represents securities firms and banks that underwrite, trade and sell debt securities. The membership includes all primary dealers in U.S. Government securities as recognized by the Federal Reserve Bank of New York and all major dealers of municipal and corporate bonds, Federal agency securities, mortgage- and asset-backed securities and money market and funding instruments. We have offices in Washington, New York and London.

The Association does not take a position with respect to the merits of Eurex's application to open a U.S.-based futures exchange. It is our view the Eurex application should be given full and fair consideration by the Commodity Futures Trading Commission (CFTC) and evaluated solely on Eurex's ability to satisfy established legal and regulatory requirements. We do not believe an exchange's country of origin should be a factor in determining compliance with statutes and regulations. Indeed, one of the principal goals of the Commodity Futures Modernization Act of 2000 was to promote competition among exchanges and to recognize the role that technology has played in the evolution of the markets.

The Association's members are firm believers in free and fair financial markets. Competition helps ensure issuers of fixed-income securities are able to borrow at the lowest interest rates possible. The same holds true for competition among exchanges that facilitate trading in financial products. Fair competition leads to greater efficiencies that are realized by market participants in the form of lower costs and risk.

Financial futures are an integral part of the financial markets that play a sometimes unnoticed, but critically important, role in the global economy. Any development that brings users of financial futures greater choice, and therefore better pricing and efficiency, will have a positive effect on the overall economy. More efficient financial markets mean lower borrowing rates for individuals, corporations and government. Investors benefit with better pricing and liquidity.

THE ROLE OF FINANCIAL FUTURES IN THE BOND MARKETS

Bonds are essentially loans. When investors purchase bonds, they buy the right to a stream of interest payments and the repayment of the bond's face value at ma-

turity. The "issuer" of a bond—the borrower—is obligated to make the interest payments on specified dates. When the bond matures, the issuer must repay the face value or principal amount of the security.

Investors can choose among bonds issued by a variety of governmental bodies and corporations. U.S. Government securities are issued by the Treasury Department to fund the operation of the Government and Federal agencies issue bonds to support low-cost mortgage loans and other investments. State and local governments issue municipal bonds to fund schools, roads, drinking water systems, airports and a variety of other public infrastructure. Corporations issue corporate bonds to finance capital investments in new plants, equipment and technology.

There are a number of different participants in the bond market, from underwriters and dealers to issuers and investors—all of whom use and benefit from a strong and active financial futures market.

ISSUERS

Issuers include any entity with a need for financing and the capacity to attract investors. For Federal, state and local governments, who are unable to raise equity capital by issuing stock, bonds are one of the only sources of long-term capital available to finance investment. For corporations, bonds can prove a lower cost source of capital than bank borrowing, and an attractive solution to the financing of long-term projects.

Issuers sometimes use financial futures to lock in a borrowing rate if present market conditions are favorable but the need to actually issue interest rate-sensitive securities will not occur until a point in the near future.

INVESTORS

Because the investor knows the return on a bond held to maturity, they may consider it a safer investment than a stock. The return on stocks is based on dividends and capital appreciation. Investors cannot be certain the company will pay a dividend or how the market will value the stock over time. Investors cannot be certain how the market will value a bond over time either, but they can remain confident the bond will continue to produce coupon payments and ultimately a principal payment.

Bond portfolios, however, are sensitive to short-term changes in interest rates. An investor may wish to limit this risk by using financial futures to create a position that offsets some or all of their bond exposure. Alternatively, investors can use futures contracts to leverage the return—and risk—of their portfolios, since futures make it possible to control a large volume of securities with a relatively small initial cash investment.

BROKERS AND DEALERS

Bond dealers are securities firms or departments of commercial banks engaged in the underwriting, trading and sale of debt securities. Investment bankers work with the issuer to develop the structure and price of a bond issue. Structure includes elements such as the bond's maturity and the coupon it will pay. Pricing a bond issue entails gauging investor interest in the deal and adjusting the yield, so it is attractive for both the issuer and the investor.

Besides using the financial futures markets to hedge interest rate risk in their securities inventories or other investment positions, brokers and dealers often use their expertise to speculate on future interest rates or currency movements using financial futures. This type of trading adds liquidity to the futures markets and increases the likelihood all market participants can find competitively priced futures contracts.

MARKET MAKING AND THE NEED FOR HEDGING WITH FINANCIAL FUTURES

Bonds generally do not trade on a centralized, organized exchange or trading system like stocks. Rather, the bond market is a decentralized, over-the-counter (OTC) market. When an investor wants to sell a bond in the secondary market, he or she usually sells the bond to a dealer. The dealer then attempts to resell the bond to another investor. This function is known as "market-making." The time between when a dealer buys a bond and when the dealer sells the bond, the bond is said to be in the dealer's "inventory." During the time that the bond is in the dealer's inventory, the dealer faces a risk the bond's price will fall before it can be sold to another investor and that the dealer will incur a loss on the transaction. An active and liquid market depends on the willingness of bond dealers to put capital at risk

by buying and selling bonds aggressively. (A liquid market is one in which a given asset can easily be bought or sold.)

Bond dealers also use a technique known as hedging to protect the value of their bond inventories from market swings. Hedging is a way to mitigate risk associated with trading. It involves taking a trading position that offsets another position so that when one position falls in value, the other rises to countervail the loss. Take the example of a dealer who purchases $1 million in 10-year Treasury notes in order to fill the demand of a customer to sell the security. If market interest rates should rise after the dealer makes the initial purchase, the face value of the bonds in inventory will fall and the dealer will realize a loss. To protect against such a turn of events, the dealer can hedge the position by buying or selling futures contracts in order to create an off-setting position. If the dealer wanted to hedge their position, they would purchase Government bond futures contracts to sell the same amount of 10-year notes. As the dealer sells off the inventory, they can also sell off, or unwind, the futures contracts that serve as a hedge.

What is most important to the bond dealer in this position is the ability to easily purchase and sell the futures contracts at fair prices and low costs. This is also important for the bond issuers, investors and the financial system as a whole. The deeper and more liquid the futures market, the easier and more economically dealers can hedge their position. This, in turn, encourages dealers to commit more capital to making a market in bonds. Increased dealer activity aids liquidity.

Hedging is important to dealers and others who actively trade bonds and other fixed-income securities. Every day, nearly $800 billion of Treasury, agency, mortgage- and asset-backed, corporate and municipal bonds change hands. In virtually every transaction, one or more bond dealers put their capital at risk in acting as a counter-party and market-maker.

A liquid market appeals to investors who are generally more willing to purchase a bond if they know they can sell it again at a fair market prices should they need to. In an illiquid market, an investor may find there are so few parties willing to purchase a given bond that the best market prices do not reflect the bond's fair value. The easier and cheaper it is for dealers to hedge their trading positions using futures, the more liquid is the cash market for the underlying bond or other financial product. The more liquid a market is, the less risky it is for investors to hold securities in that market. The less risk investors face, the lower return they demand when initially buying securities from issuers. Bond issuers benefit from a liquid market as it generally means investors will demand lower interest rates on the issuer's bonds. Fostering competition among futures exchanges will, in the end, make it less costly for the Federal Government, states and localities, corporations and individual families to borrow.

Our fair and open markets for financial futures ultimately benefit participants at every level of the financial markets. More efficient financial markets mean lower borrowing rates for individuals, corporations and government. Investors benefit with better pricing and liquidity.

The Association believes one of the keys to our fair and open financial futures markets is competition among the exchanges that facilitate trading in financial futures contracts. Congress has recognized this, most recently in 2000 with the Commodity Futures Modernization Act, as well as the role technology can play in promoting competition.

The CFTC has long recognized that promoting efficient markets is good public policy. We are confident the CFTC will consider Eurex's application as it would any other submission and make its decision based on the merits of the application. We urge the Committee to encourage the CFTC to act expeditiously and fairly in evaluating Eurex's application. Thank you for the opportunity to present our views.

STATEMENT OF DANIEL ROTH

My name is Daniel Roth, and I am president of National Futures Association. NFA appreciates this opportunity to appear here today to present our views on some of the issues arising in connection with Eurex U.S.'s pending application for designation as a U.S. contract market (DCM). At the outset, let me preface my remarks by stating that I am not here to take a position as to whether the CFTC should approve or disapprove Eurex U.S.'s application as a DCM or, for that matter, what the Commission's timetable for reviewing that application should be. However, I wish to describe for you how NFA operates as a registered futures association (RFA) and what regulatory services NFA's Executive Committee has authorized the organization to provide Eurex U.S. if it is approved as a DCM.

First, for those of you that may not be familiar with NFA, we are an industrywide self-regulatory organization occupying a unique position in the futures industry. Like the exchanges, we are a self-regulatory body, but, unlike the exchanges, NFA does not operate a marketplace. Self-regulation is not part of what we do—it is all that we do. Like the trade associations, we are a membership organization, but, unlike those associations, we are not a lobbying organization. We are first, foremost and only a regulatory body devoted to customer protection.

Our 4,000 Members include futures commission merchants (FCMs), introducing brokers (IBs), commodity pool operators (CPOs) and commodity trading advisors (CTAs). We also regulate the activities of approximately 50,000 registered account executives who work for those Members. NFA's twenty-five person Board of Directors (Board) has representatives from all our Member firm categories as well as six futures exchanges and five public directors. Our mission is to work as a partner with the CFTC to provide the industry with regulation that is both as effective and as efficient as possible. We think this partnership has been an extraordinary success. In the twenty-one years since NFA began operations, trading volume on U.S. futures exchanges has increased by over 400 percent. During that same time, customer complaints have actually dropped by over 70 percent.

We all know, though, that a successful past does not ensure a successful future. The need for regulation that is both effective and efficient has never been greater. Effective regulation is the best way to assure public confidence, and we have all seen what happens to markets that lose the public's confidence. The best way to preserve that confidence is to deserve it—to ensure that the highest levels of integrity are demanded of all market participants and intermediaries.

Efficient regulation is not just a question of how you write the rules—it also involves making the best use of regulatory resources. For the last 21 years, NFA has steadily expanded its regulatory role through either delegation of responsibilities from the CFTC or actively seeking additional regulatory responsibilities. Regardless of how our role has expanded, we have always made a commitment to retaining any expertise necessary to perform any additional responsibilities in a high-quality manner. At this time, let me describe each area of our expanded roles.

DELEGATIONS BY THE CFTC

Over the years, the CFTC has entrusted NFA with certain of its frontline regulatory responsibilities to avoid duplication of effort and to direct its own resources where they are needed most. That trend has continued and accelerated since the passage of the Commodity Futures Modernization Act of 2000 (CFMA).

For example, last January, the Commission delegated to NFA the authority to review the annual financial reports that CPOs are required to provide to the CFTC and to their customers. This delegation eliminated the burden of filing those reports with both the CFTC and NFA. At the same time, NFA collaborated with the CFTC to implement technology that allows CFTC staff to electronically access and query information NFA maintains relating to pools in our databases. During the last six months, NFA's compliance staff has analyzed over 2,600 pool financial statements filed by CPOs with NFA.

Additionally, in mid-March, the CFTC authorized NFA to review the prospectus-type disclosure document that CPOs provide to customers for publicly-offered commodity pools. In 1997, the CFTC delegated this responsibility to NFA for disclosure documents for privately offered commodity pools, and managed account programs offered by CTAs. NFA's team of specialists review about 200 disclosure documents each month, with an average turnaround time of a few days.

These two delegations are just the latest example of a long list of additional responsibilities that the CFTC has given to NFA over the years. The Commission has delegated to NFA responsibility for processing registration applications for all categories of registrant; for revoking and denying registrations where appropriate; and for processing applications for exemptions from registration for foreign firms. To enhance and bring greater efficiency to our registration responsibilities, NFA internally developed an Internet based registration system—NFA's Online Registration System. During the Summer of 2002, this system went live and has been met with virtually unanimous approval by both Members and the CFTC. This system allows an individual to receive registration instantaneously and allows a firm to easily monitor its registration activities.

In addition to these formal delegations, NFA constantly works informally with the CFTC. For example, NFA and the CFTC both take their customer protection mandates very seriously and have always had an excellent relationship working together on enforcement matters. I should note that last year NFA alone issued over 27 disciplinary complaints against 100 respondents, and issued 35 disciplinary decisions

that ordered 24 expulsions and 23 suspensions from membership, and assessed over $650,000 in fines. Additionally, during the last year, NFA has assigned three compliance employees to the CFTC to help the Commission conduct investigations relating to energy and off-exchange foreign currency transactions.

DELEGATIONS BY CONTRACT MARKETS

Section 113 of the CFMA allows, in part, contract markets to comply with their self-regulatory responsibilities by delegating any relevant function to NFA, an RFA. If a DCM elects to make such a delegation, the CFMA provides that the DCM shall remain responsible that the function is carried out. Section 113 essentially codified a position previously taken by CFTC staff in a 1975 staff advisory.

As early as the Spring of 1999, NFA's Board discussed and approved the first of several strategic planning reports. One key initiative of the 1999 report focused on NFA adding value to the industry by offering to perform self-regulatory functions on behalf of existing and new electronic futures exchanges. In February 2001, the Board again discussed and reviewed NFA's strategic plan and unanimously approved an amendment to Article III of NFA's Articles of Incorporation to make clear that the new regulatory services offered by NFA were consistent with NFA's fundamental purposes. Specifically, NFA's Articles were amended to state that one of NFA's fundamental purposes is to provide such regulatory services to such markets as the Board may from time-to-time approve. This Articles amendment was subsequently adopted by membership vote and approved by the CFTC.

The strategic plan adopted by the Board allowed staff to offer regulatory services to both traditional DCMs and to those markets that are not required to perform self-regulatory responsibilities but voluntarily chose to do so. During the last four years, staff has worked to implement the Board's strategic initiatives and has continually kept NFA's Board advised of its progress.

To date, NFA's Executive Committee has unanimously authorized staff to execute Regulatory Services Agreements with four electronic exchanges—BrokerTec, Merchants Exchange, Island Futures Exchange, and OnExchange. Each time this committee authorized staff to enter into one of these agreements, staff informed the entire Board at its next scheduled meeting. At the present time, staff performs services for two markets—Merchants Exchange and BrokerTec, which both currently operate at low volume levels. NFA did not perform regulatory services for these exchanges until the CFTC approved their respective DCM applications. The committee should also be aware that NFA has previously offered to perform these services for two other DCMs—OneChicago and NQLX—but these exchanges selected others to provide these services. For example, OneChicago, owned by the CBOE, CME and CBOT, contracted with the CME and NQLX, owned by Euronext.liffe, through the legal entity LIFFE (Holdings) plc, has an agreement with NASDR.

At this time, it is very important for me to note that NFA's senior management and Board both recognized that NFA would need to obtain special expertise to perform trade practice and market surveillance functions delegated to NFA by a DCM. Therefore, our first step in implementing NFA's strategic plan was to hire Yvonne Downs in early 2000. Prior to joining NFA, Ms. Downs worked at the CBOT for almost 20 years. In 1995, the CBOT promoted her to Senior Vice-President and Administrator of the Office of Investigations and Audits. In that position, her responsibilities included the supervision of five regulatory divisions: audits, financial surveillance, investigations, market surveillance and regulatory reporting. Under Ms. Down's direction, NFA developed its own market surveillance and trade practice program (TPMS). The principal tool NFA uses for trade practice and market surveillance is the internally developed Trade Analysis and Profiling System (TAPS).

NFA's market surveillance activities are focused on detecting potential manipulations and price distortions and ensuring the orderly liquidation of expiring contracts. In performing this responsibility, staff uses online quotation systems, computer-generated reports and other tools to conduct daily monitoring of prices, volume, open interest, clearing member and large trader positions, and market news for all contracts listed on an exchange. Through TAPS, staff has access to a contract's historical price record and provides exception report alerts whenever upward or downward price moves exceed preset parameters. Staff can also review the previous day's trading volume and open interest for each contract. TAPS also enables staff to view trade and volume information by clearing member or by firm, and to rank positions in each contract by size. TAPS sends an alert to staff if any trader has a percentage of either volume or open interest beyond preset parameters.

Obviously, an exchange's large trader reporting system is an integral function of TAPS. The system has preset alerts that inform staff whenever a trader has met the threshold for large trader status. NFA then obtains a large trader report from

the trader, and enters the information into TAPS' large traders list, which aggregates all positions held by related parties. Once this information is compiled, staff monitors large trader positions for concentrations of ownership and potential collusive or concerted activity by market participants. If it appears that any one trader or account controller has a concentration in a given commodity, staff will contact the trader or controller to determine the reason for the concentration. TAPS also enables NFA staff to view complete information regarding each large trader's trading history at any time.

As contracts approach their expiration dates, staff uses the information in TAPS about the trading patterns of firms and traders to pay particular attention to large trader open interest and volume. TAPS also produces exception reports which alert staff whenever basis relationships do not narrow as expected with the approach of a contract's expiration.

TAPS also creates exception reports designed to identify various types of potential trading abuses and other anomalous trading activity. TPMS staff reviews all of the exception reports on a daily basis. The types of exceptions include trading ahead of customers, wash trading, and marking the close. In addition to conducting an exception report review, staff also uses TAPS to conduct customized searches or reviews of an exchange's audit trail data. Staff thereby has the flexibility to tailor queries based on, for example, the time of a transaction, order type, quantity or price.

TAPS also maintains trader profiles, which include average time logged on, average number of trading days per month, frequency of trading, average trade size, profit and loss history, frequent counterparties, and percentage of total volume in a given market. The system's exception reports alert staff to deviations from a trader's profile, such as those involving unusual profit patterns, significant changes in volume, and unusual concentrations of trading activity between the same counterparties.

Obviously, NFA staff works closely to coordinate its market surveillance and trade practice activities with exchange compliance staff. As previously noted, the exchange is ultimately responsible for fulfilling its self-regulatory functions. The exchange staff also has market supervision responsibilities and an obligation to closely monitor the daily activities on its market. If NFA staff determines that trading activity requires further scrutiny, staff will initiate an investigation and, if in our view the facts warrant formal disciplinary charges, staff prepares a report that is forwarded to the exchange. If the exchange's compliance department concurs with staff's analysis, then the action will proceed to the exchange's disciplinary committee for resolution.

For each of the four exchanges that has executed an RSA with NFA, the CFTC was aware in reviewing each DCM application for approval that NFA had been selected to perform regulatory services for the exchange. Prior to approving each exchange's application, the CFTC performed an extensive review of NFA's TPMS program, including TAPS and our staffing levels. Additionally, just earlier this month, the CFTC completed a rule enforcement review of BrokerTec's market surveillance, audit trail, trade practice surveillance and disciplinary programs. In this review, the Commission found that NFA had adequate programs in place to monitor BrokerTec's trading.

Each RSA previously approved by our Executive Committee sought to ensure that NFA was not exposed to either financial or reputational risk by performing these regulatory services. We have followed that same course in negotiating an RSA with Eurex U.S. This RSA's financial terms are designed to recover NFA's costs, providing for payment of a fixed monthly fee and a fee that is scalable to volume, allowing us to add staff to match an increase in activity. Additionally, we realize that NFA's reputation could be harmed if Eurex U.S. either imposes barriers that make it difficult for NFA to perform regulatory services and uncover wrongdoing or fails to follow our recommendations in addressing regulatory problems. If either event occurs, NFA has the right to cancel the RSA with Eurex U.S. and inform the CFTC of our reasons for doing so.

NFA's Executive Committee met last month and voted 7–1, with one abstention, to authorize staff to execute an RSA with Eurex U.S. NFA will inform our Board of the Executive Committee's action at the next Board meeting and like any other Executive Committee action, the Board may elect to review NFA's agreement with Eurex U.S.

Although both Congress and the Commission have allowed NFA to expand its role, our mission today is the same as it was twenty-one years ago. Everything we do is for a regulatory purpose designed to protect customers, protect market integrity and protect the public's confidence in these vital markets.

STATEMENT OF JOHN M. DAMGARD

Mr. Chairman, members of the committee. On behalf of the Futures Industry Association (FIA), I want to thank you for the opportunity to appear before you today to discuss the application of the U.S. Futures Exchange LLC for designation as a contract market. FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 40 of the largest futures commission merchants (FCMs) in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than 90 percent of all customer transactions executed on United States contract markets.

When Congress amended the Commodity Exchange Act through the Commodity Futures Modernization Act of 2000, an underlying purpose, as expressed in the Act, was "to promote responsible innovation and fair competition among boards of trade, other markets and market participants." The application of the U.S. Futures Exchange, an indirect subsidiary of Eurex, marks an important step in realizing the vigorous competition among markets that Congress anticipated in the CFMA.

Attached to my statement is a copy of the comment letter that FIA has filed with the Commission in support of the U.S. Futures Exchange application. I respectfully request that it be made a part of the record here. I will not repeat the points made in that letter. Instead, my comments today will focus on two issues with respect to which the committee indicated particular interest: the process for designation as a contact market and the U.S. Futures Exchange self-regulatory program.

THE DESIGNATION PROCESS

The CFMA signaled a radical new approach to the regulation of the derivatives markets. Prior to enactment of the CFMA, the Commission's prescriptive regulations had unnecessarily delayed the approval of new contracts and the introduction of innovative trading procedures. To replace these regulations, Congress set out a limited number of broad criteria that an applicant for designation would have to meet in order to be approved as an exchange and certain core principles with which the exchange would have to continue to comply in order to maintain its designation. Consistent with its goal of promoting responsible innovation, Congress further provided that the exchange "shall have reasonable discretion in establishing the manner in which it complies with the core principles."

Significantly, Congress removed the requirement that an exchange identify the contracts that it intended to list for trading in connection with its application for designation as a contract market. As with existing exchanges, therefore, an exchange applicant is permitted to wait until it has been designated as a contract market and may then list its contracts by certifying to the Commission that the contract complies with the provisions of the Commodity Exchange Act. This provision of the law assures that new exchanges and existing exchanges are on a level playing field with respect to the listing of new contracts.

Congress also specifically removed the statutory requirement that effectively required the Commission to publish applications for designation for comment in the Federal Register. This change in the law promised to expedite the review and approval of new exchanges. More important, it confirmed that the Commission, as the expert agency responsible for the regulation of derivatives markets, is best suited to determine whether an applicant meets the statutory criteria and is able to comply with the core principles that Congress established.

As a result of these amendments to the Act, the Commission is under no obligation to request public comment from interested parties prior to determining whether an applicant meets the criteria specified in the Act. Congress has left the decision to seek comment—and the manner in which it seeks comment—to the Commission to determine in its sole discretion. In this regard, we note that, since the enactment of the CFMA, the Commission has designated four new contract markets: OneChicago; Nasdaq-Liffe Markets (NQLX); Island Futures Exchange; and CBOE Futures Exchange. In each instance, the Commission approved the applications without requesting comment from the public. Although the industry's experience under the CFMA is obviously limited, we have seen nothing to date that would cause us to recommend a change in the Commission's authority.

In providing a 30-day period for public comment on the U.S. Futures Exchange application, the Commission presumably determined that its review could benefit from receiving the views of the industry, although it did not request comment on any specific aspect of the exchange application. As discussed above, that is the Commission's decision to make in its sole discretion. Nonetheless, we caution that the

Commission must take care not to adopt different procedures for certain applicants that may appear to be designed solely to prevent new entrants from establishing their business in a timely manner. Such actions would clearly be contrary to congressional intent in enacting the CFMA.

In this regard, it is important to remember that Eurex is not an unknown entity to the Commission. To the contrary, over a period of more than seven years, in connection with various requests for regulatory relief from U.S. requirements, the Commission has had several opportunities to review Eurex, its operations and the rules and regulations to which it is subject. Each time, it has found no reason not to grant Eurex the same relief that other foreign exchanges were granted.

For example, in 1999, the Commission staff adopted a no-action position, authorizing Eurex, among other foreign markets, to place terminals in its members' offices in the U.S. for trading in certain Eurex contracts. Before adopting this position, the staff conducted a thorough review of Eurex including its operating and trading rules, its trading system, its settlement and clearing system and its compliance programs. In 2000 and again in 2002, the Commission staff adopted no-action positions authorizing the offer and sale of certain stock index futures contracts listed for trading on Eurex. More recently, the Commission, pursuant to its rule 30.10, granted an exemption from registration for firms authorized by Eurex that wish to solicit orders from U.S. customers trading on that exchange. In granting this latter exemption, the Commission specifically found that Eurex is subject to a regulatory scheme that is comparable to that to which U.S. exchanges are subject.

We also want to emphasize that the lack of a public comment period has not denied FIA the opportunity to express its views with respect to the organization, operation and rules of exchange applicants. Rather than dealing indirectly through the Commission, however, we now work directly with the relevant exchange or clearing organization, a change in procedure that has proved to be both more efficient and more productive. For example:

• In connection with the applications of OneChicago LLC and NQLX, the Security Futures Committee, composed of representatives of FIA member firms and member firms of the Securities Industry Association, met often with the staffs of these exchanges and provided both oral and written comments. Our goal was twofold. First, we wanted to assure to the extent possible that the exchange rules were designed to facilitate the efficient execution of transactions in the security futures products that would be listed on each exchange. Second, we wanted to be certain that any operational issues our member firms identified were resolved prior to the initiation of trading.

• Immediately following the announcement of the clearing link between the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBT), FIA advised the leadership of both exchanges that we were ready to work with them to resolve the numerous questions that were certain to arise as the business and operations details of their arrangement were implemented. To this end, we formed an ad hoc committee under the leadership of Craig Smithson, Executive Director of UBS Warburg.

• As with OneChicago and NQLX, representatives of FIA member firms have held a number of meetings with the staff of the U.S. Futures Exchange to discuss its rules and operational structure. In particular, we have recommended several changes to their trading procedures, which the exchange has agreed to consider.

• Finally, we recently formed an ad hoc committee to work with the U.S. Futures Exchange and The Clearing Corporation to resolve operational issues as they develop their clearing link.

SELF-REGULATORY PROGRAM

As the committee is aware, in connection with its application for designation, the U.S. Futures Exchange has contracted with the National Futures Association to perform on behalf of the exchange essentially all of the market surveillance and compliance programs that exchanges are required to implement. Although we have every confidence in NFA's ability to perform these functions, the Commission ultimately will determine whether NFA's programs are properly designed to permit U.S. Futures Exchange to meet its statutory obligations through NFA. As a matter of policy, FIA supports the exchange's decision to delegate these responsibilities to NFA. As a matter of law, the CFMA amendments to the Act specifically provide that a "a contract market . . . may comply with any applicable core principle through delegation of any relevant function to a registered futures association or other registered entity." NFA, of course, is a registered futures association.

We note that the contract between the U.S. Futures Exchange and NFA is not unique. NFA currently performs self-regulatory functions for BrokerTec Futures Ex-

change and the Merchants Exchange. NFA also has a contract with Island Futures Exchange to perform services when that exchange begins trading. Similarly, OneChicago has contracted with CME to perform certain of its self-regulatory functions, while NQLX has a contract with the NASD.

The decision of a new exchange to contract with an established self-regulatory organization should be welcomed, not challenged. In a 2000 White Paper entitled "Reinventing Self Regulation", which was recently updated and reissued, the Securities Industry Association identified certain guiding principles for securities self-regulatory organizations that are no less applicable to the futures industry. Specifically, SIA stated that any self-regulatory structure should:

- Foster Investor Protection;
- Preserve Fair Competition;
- Eliminate Inefficiencies;
- Encourage Expert Regulation;
- Promote Reasonable and Fair Costs of Regulation;
- Foster Due Process; and
- Encourage Industry Participation and Self-Regulation.

We submit that the public and the industry can have greater assurance that these seven purposes will be achieved—and an exchange will be able to perform its statutory responsibilities more effectively—if it retains the services of an experienced self-regulatory organization rather than attempting to build its own. As an economic matter, requiring an exchange to maintain its own staff to perform these functions would likely create an insurmountable barrier to entry that would inhibit any entity from applying for designation.

We do not know if the U.S. Futures Exchange will succeed, assuming its application is approved. Capturing liquidity from existing exchanges is exceptionally difficult in the best of circumstances. Market participants have demonstrated a well-earned confidence in U.S. exchanges and convincing these participants to trade elsewhere will not be easy. Nor is there any certainty that contracts currently listed for trading on Eurex will be successful if listed for trading here.

However, we do know that competition invariably improves markets. In fact, in recent months we have seen reductions in fees and welcome changes in trading rules that we believe have been adopted in anticipation of the U.S. Futures Exchange application. These changes benefit both customers and intermediaries by reducing costs and facilitating the execution of certain transactions.

FIA wants to emphasize that our support for competition is not limited to foreign exchanges that may wish to list products currently traded on U.S. markets. We support competition across all markets and all products. In this regard, FIA has consistently pointed favorably to the experience in the equity options markets, where the ability to list fungible products on multiple markets that then are cleared through a common clearing organization has led to a dramatic increase in competition among all exchanges. Our members compete on a product-by-product basis daily. We see no reason why exchanges should not be subject to similar competitive pressures.

We also see no obstacles that would prevent the Chicago Mercantile Exchange and the Chicago Board of Trade, in particular, from taking the fight to the U.S. Futures Exchange. CME and CBT, in the aggregate, account for approximately 85 percent of all U.S. futures exchange volume. In achieving this position, they have demonstrated that they are both fierce and able competitors.

As I noted when I began my remarks, an underlying purpose of the CFMA is "to promote responsible innovation and fair competition." Provided an applicant meets the criteria specified in the Act and the Commission's regulations, an exchange should be designated as a contract market upon the same terms and conditions—and pursuant to the same procedures—to which all other applicants are subject.

It is worth remembering that, when foreign exchanges first applied to the Commission for authority to place their terminals in the U.S., many U.S. exchanges, including those represented here today, argued that the foreign exchanges should be required to come to the U.S., apply for designation as contract markets and compete with U.S. exchanges on a level playing field. Eurex has agreed to meet this challenge, establishing a subsidiary here to compete with other U.S. exchanges on the same terms and conditions—and subject to the same laws and regulations—to which all U.S. exchanges are subject. FIA would be greatly troubled if the world's largest futures exchange, or other entrants that are willing and able to comply with U.S. laws and regulations, were unfairly denied this opportunity.

Thank you again for the opportunity to appear with before you today. I would be happy to answer any questions you may have about the process at the Commission or any other areas of interest to you.

ANSWERS TO SUBMITTED QUESTIONS

You have a long experience of analyzing exchange governing structures. Are you concerned with regard to any aspect of the governance of Eurex US? What expectation do you have for the ultimate composition of the Eurex US Board? Should a greater share of Board sets be dedicated to non-shareholders or others with a stake in the business?

We believe the governance structure of the Eurex US compares favorably with the governance structures currently in place at other U.S. futures exchanges. The boards of directors at US futures exchanges remain dominated by representatives of the floor community with little or not participation from any other industry segments. In contrast, representatives of Eurex US have represented that its board of directors, which will be comprised of approximately 12 members, will represent all segments of exchange participants. The exchange has also stated that it will comply with all corporate governance requirements applicable under U.S. law to U.S. futures exchanges generally.

In this latter regard, the Commodity Futures Trading Commission is currently conducting a review of the roles, responsibilities, and capabilities of self-regulatory organizations in the context of the market changes that have taken and are taking place. We understand that, among other matters, the Commission is reviewing the governance structures of the exchanges. We would expect that, in connection with this review, the Commission will examine the changes in governance that the New York Stock Exchange recently implemented and, in particular, its decision to require all board members (with the exception of the CEO) to be independent of both exchange members and exchange management. In the event the Commission makes any recommendations with respect to the structure of exchange boards of directors, we would encourage all exchanges, including Eurex US, to give them appropriate consideration. The FIA expects to play an active role in any industry-wide initiative and we appreciate the foresight of Chairman Newsome in initiating the undertaking.

Are U.S. exchanges able to do in German what Eurex proposed to do here? Please comment with regard to reciprocity issues. If a US entity applied to open an exchange in Germany tomorrow, could it have a reasonable expectation of getting a decision from German regulators within 6 months?

We will defer to other hearing participants on the question of German law and policy. However, we would caution that it appears the Commission has had informal discussions with Eurex for several months before the formal application was filed. This is the procedure, as we have observed, that all exchange applicants follow in preparing a final application for submission. Therefore it is difficult to compare the time it takes to seek designation and commence business as an exchange in each jurisdiction.

STATEMENT OF MICHAEL MCERLEAN

Chairman Goodlatte, Ranking Member Stenholm, distinguished members of the committee, thank you for inviting U.S. Futures Exchange here today. U.S. Futures Exchange is a U.S. company, whose parent company, U.S. Exchange Holdings Inc., is a 100 percent subsidiary of Eurex Frankfurt AG, which in turn is owned by Deutsche Boerse and SWX Swiss Exchange. Deutsche Boerse is a publicly traded company listed on the Frankfurt Stock Exchange and is majority owned by UK and U.S. institutional investors. The company is owned by a total of 36,000 shareholders; the largest shareholder is a U.S. institutional investor. Only two shareholders hold a stake larger than five percent; both of these are U.S. entities. SWX Swiss exchange is owned by 55 financial institutions. We are also in negotiations with a broad range of market users as potential shareholders of U.S. Futures Exchange.

We welcome this opportunity to submit testimony regarding our application with the Commodity Futures Trading Commission (CFTC or the Commission) for designation as a new U.S. contract market. We applaud this committee's continued interest in the integrity and competitiveness of the U.S. futures markets and are pleased to have the opportunity to share with the committee our plans and to answer any questions that the committee may have regarding our application for contract market designation.

Congress decades ago recognized the global character of the futures markets and the need for cross-border access to foreign markets, unencumbered by restrictive regulatory constraints. This principle was codified in the Commodity Exchange Act

as section 4b(c), which prohibited the CFTC from regulating access by U.S. persons to foreign markets. This policy proved prescient and has been enormously successful. In this new environment, our U.S. exchange will provide U.S. participants with the same access to foreign products that they already enjoy through remote access to foreign exchanges, with the added benefit that they will be trading through an exchange that wishes to subject itself fully to U.S. regulation, rather than through a foreign exchange operating abroad.

REGULATORY BACKGROUND

U.S. Futures Exchange filed its application for contract market designation with the CFTC on September 16th. As the committee is aware, the CFTC published our application for public comment and subsequently extended the initial 15-day comment period to 30 days. We have made available for public review and comment significant elements of the materials that we filed in support of our application and have been working cooperatively with the CFTC to provide such additional information as the Commission may request and to resolve issues identified by the Commission. U.S. Futures Exchange endorses the transparency of this process, as it is fully consistent with Eurex's own policy of transparency and responsiveness to market participants. Accordingly, we consider the public comment period to be an extremely positive and important part of the U.S regulatory framework.

We welcome any comments on our application and intend to respond expeditiously to any and all legitimate issues that may be raised in the process.

U.S. FUTURES EXCHANGE BUSINESS PLAN

U.S. Futures Exchange will be based in Chicago. All operations of the exchange will be conducted out of our Chicago headquarters, now under construction, in the Sears Tower. U.S. Futures Exchange will obtain critical regulatory and clearing services from the National Futures Association and The Clearing Corporation (formerly, the Board of Trade Clearing Corporation), also located in Chicago.

In short, U.S. Futures Exchange will operate as a U.S. company, located in the U.S, staffed by U.S. employees, acquiring services from U.S. service providers, and subject—in all respects—to the same U.S. regulatory framework that is applicable to all U.S. futures exchanges.

Our business model has been designed to offer U.S. market participants, customers, and end-users a wide variety of benefits, including enhanced market efficiency, greater market transparency, equal market access and lower costs. To this end, Eurex expects to utilize a modern structure and proven, best of breed, technologies and service providers. Specifically:

Proven market environment. U.S. Futures Exchange will operate a 20 hour/day all-electronic trading platform utilizing proven, scaleable, state of the art technology developed by Eurex, our European parent. This platform is currently utilized by the Chicago Board of Trade under license from Eurex AG and executes more than 80 percent of the volume in the U.S. Treasury Bond futures market through a joint venture between Eurex and CBOT which ends this year. U.S. Futures Exchange will provide market participants access to the same trading environment that the Chicago Board of Trade has been using for the past 3 years and is currently utilizing, under license from Eurex and subject to CFTC oversight, for its a/c/e system.

Open market model. Access to U.S. Futures Exchange will be available to all market participants who satisfy the exchange's non-discriminatory eligibility requirements. Access will not be artificially restricted to a limited number of market participants who benefit financially and otherwise from restricted membership. All market participants who wish to do so may have the benefit of direct access to the exchange and the exchange's favorable rate structure.

Level playing field; market transparency. All market participants will have equal access to the market and the same rights in executing their business. There will be no privileges and no physical environment that segregates the direct and immediate access of members from the indirect access of non-members as is currently the case on major U.S. futures exchanges. All market participants will have equivalent access to a competitive and non-discriminatory execution environment. This same environment provides a level of transparancy that is equal for all market participants and fosters no informational or other trading advantages to a restricted constitutency of insiders.

Reduced trading costs. The cost of trading on U.S. Futures Exchange will, on average, be significantly lower than the current cost of trading on the major U.S. futures exchanges. Investors, e.g. U.S. pension funds, will pay 30 cents or less per U.S. Treasury bond futures contract on U.S. Futures Exchange, significantly lower than the CBOT charges. This will result in significant savings for a wide range of

market participants. However, as a result of the greater competition that U.S. Futures Exchange will bring to the market, we fully expect that all U.S. market participants—and not just U.S. Futures Exchange's customers—will ultimately benefit from lower trading costs as a direct result of U.S. Futures Exchange's market entrance.

Additional products. U.S. Futures Exchange will list for trading a broad range of derivatives products including derivatives contracts on U.S. and European interest rates and indices. Availability of certain products will be subject to an arrangement, to be finalized, between our U.S. clearing partner, The Clearing Corporation, in Chicago and Eurex Clearing AG in Germany. These European interest rate benchmarks currently are not traded on any other U.S. contract market. Some of these instruments will, for the first time, offer U.S. market participants and customers the opportunity to manage their European interest rate and equity exposures directly on a U.S. futures exchange.

Financial integrity. Clearance and settlement services for all trades on U.S. Futures Exchange will be provided by The Clearing Corporation, a registered U.S. derivatives clearing organization, formerly known as the Board of Trade Clearing Corporation, with whom we have entered into a Clearing Services Agreement. The Clearing Corporation is a venerable financial institution that has been in operation in Chicago for 78 years, and is widely regarded as the preeminent U.S. provider of futures clearing services to the financial and agricultural trading communities. The inability of U.S. Futures Exchange to enter the U.S. market on an expeditious basis could, as the CBOT has itself noted, lead to the demise and dissolution of The Clearing Corporation. We hope instead that, as our clearing partner, The Clearing Corporation will continue to fulfill its historic role as a leading Chicago financial institution and employer long into the future.

Market integrity. Our customers will enjoy the highest level of market integrity. Trading on U.S. Futures Exchange will, consistent with customer protection, be completely anonymous from the time of order entry all the way through contract settlement and delivery. U.S. Futures Exchange will have a full, immediate, and unalterable audit trail of all activity and transactions that occur on the trading platform. In addition, U.S. Futures Exchange has contracted with the National Futures Association to conduct market and trade practice surveillance, and to perform other regulatory duties for the exchange. The National Futures Association is a highly respected CFTC-licensed self-regulatory organization and is widely recognized as the leading provider of outsourced self regulatory services to U.S. futures exchanges.

Fair governance. U.S. Futures Exchange intends to establish and implement a representative governance structure that will reflect a diverse cross section of market users. The Board of U.S. Futures Exchange is expected to comprise 12 representatives, including six representatives of the various user groups. U.S. Futures Exchange also intends to base its corporate governance infrastructure on the principle of responsiveness to the views and concerns of all categories of market participants, without discriminatory bias in the decisionmaking process.

In this connection, U.S. Futures Exchange will comply with all corporate governance requirements applicable under U.S. law to U.S. futures exchanges generally. As or perhaps even more significant, Eurex's governance structure will eliminate the structural factors that lead to significant conflicts of interest and reduce the potential for abusive conduct of the type that afflicts many exchanges in the U.S., including major U.S. futures exchanges. We believe that independent governance, together with an open market model, is a particularly powerful means of discovering and meeting customer and market needs, while maximizing fair treatment of market users and shareholders.

We also intend to broaden our shareholder base through an equity partnership with U.S. market participants and have reserved a significant stake of the company's equity for this purpose. We foresee substantial industry participation in the exchange's governance.

Demand for and Impact of Competition

We believe, based on our experience, that U.S. market users are receptive to this market model. Indeed, we believe that there is significant demand for this model and that many U.S. market participants would welcome the opportunity to trade U.S. and European contracts on a designated contract market having the characteristics described above. Moreover, it is widely recognized that the establishment of U.S. Futures Exchange 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 and all market users.

This view is supported by a comparison of the trading volumes in the U.S. market for bond futures and options with the corresponding European market for bond futures and options. The underlying market demand for management of interest rate risk is about the same in the United States and Europe. Back in 1998, the exchange-traded volume in bond futures and options in the U.S. dollar exchange traded derivatives market was 1.5 times larger than the trading volumes in Euro denominated bond futures and options. Today the exchange traded European derivatives market is significantly larger than the U.S. derivatives market. This demonstrates the dramatic impact that a more democratic market model, effective competition and innovation can have on growth in the market. We hope that by offering direct access to U.S. dollar denominated products to customers worldwide, U.S. Futures Exchange will both support and expand the growth of the U.S. bond futures market.

There was a period, not very long ago, when the futures industry effectively began and ended within the borders of the United States. That was because this was the only country in the world where the three basic requirements for futures trading existed in abundance:

• a critical mass of companies and individuals willing and able to use the markets efficiently;

• a tradition of operating transparent financial markets open to all; and

• a regulatory structure that protected market users without encumbering the operation of markets.

Beginning approximately 20 years ago, with the assistance of both U.S. exchanges and U.S. market participants, the idea of futures markets spread beyond the borders of this country and new markets began to develop around the world. In many ways the European exchanges modeled themselves after U.S. markets. Foreign exchanges then began to apply new methods to the trading of these products—the use of electronic trading systems for example—making it easier for a broader array of participants to participate directly in the markets. The goal was to make markets more efficient, more cost effective, more transparent—more responsive to the needs of the rapidly growing base of market users. And in doing this some European exchanges have succeeded beyond expectations—attracting traders not just from their European home markets, but from throughout the United States and the rest of the world as well. U.S. exchanges have themselves recently begun adopting that technology. The a/c/e joint venture between the CBOT and Eurex is a case in point.

U.S. Futures Exchange, as a U.S. designated contract market, is poised to offer U.S. investors the benefits available in non-U.S. markets, and to do so subject to the financial safety and customer protections provided by the U.S. regulatory framework. Today, U.S. customers can obtain those benefits only by trading on the global markets. Only on the global markets do U.S. customers have the opportunity to trade in a variety of Euro-denominated instruments. U.S. Futures Exchange plans to offer U.S. market participants access to such products with the support of The Clearing Corporation, and stands ready to offer U.S. products, on a fully U.S.-regulated domestic contract market, all cleared by a U.S. derivatives clearing organization. In the final analysis, our ability to enter the U.S. market will bring greater competition to the U.S. futures industry to the benefit of U.S. market participants, end-users, investors, and the U.S. futures industry itself. This was precisely the goal Congress had in mind when it enacted the Commodity Futures Modernization Act of 2000 (CFMA), under the leadership of this committee.

Indeed, this committee is rightly credited for its leadership role in connection with the legislation ultimately enacted as the CFMA, an act that established a modern and streamlined framework for the regulation of the U.S. futures markets. The CFMA is widely heralded as a paradigm for the balancing of private sector autonomy and governmental oversight interests. The premise for that legislation was the notion that the salutary effect of private sector market discipline would obviate the need for overly prescriptive governmental intervention, and its attendant inefficiencies. However, that premise depends entirely on the existence of competition. Without competition, or the conditions for competition, there is no market discipline. Without market discipline there is no market or other mechanism by which exchanges are compelled to be responsive to the needs of market participants. The absence of competition fundamentally undermines Congress's key objectives in enactment of the CFMA and will perpetuate the imposition of real costs and inefficiencies on the investors in these markets.

It is equally important to recognize that the benefits of competition are not necessarily limited to consumers. Competition leads to innovation and efficiency. These, in turn, can be an engine for growth that expands opportunities for all competitors in the marketplace. This is true across all economic sectors—domestic and foreign.

We and other observers fully expect that this will be the case in the U.S. futures markets.

We are pursuing this application precisely because there is an enormous and urgent demand from U.S. market participants, including among constituents of this committee, for competition, greater efficiencies, greater transparency and lower costs in the U.S. futures markets. U.S. Futures Exchange is attempting to respond to this demand by competing in these markets on a level playing field, and subject to precisely the same regulatory framework as its competitors.

We are confident that this committee will review these issues analytically and with objectivity. This committee must not be misled by those whose sole motivation is to prevent the emergence of competition in the U.S. financial futures markets, to the detriment not only of direct participants in these markets, but ultimately to all consumers throughout the U.S. economy whose cost of living is affected by the cost of interest rate products.

We are anxious to respond to any and all questions that this committee or the CFTC may have and we are confident in our ability to respond to the complete satisfaction of this committee and the CFTC.

We thank the committee for the opportunity to do so.

Hessisches Ministerium
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und Landesentwicklung
- Börsenaufsichtsbehörde -

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Datum 31. Oktober 2003

Approval of Exchanges

Dear Sirs,

further to your request I have the pleasure to send you the enclosed list of criteria which have to be fulfilled by any Institution which applies for the approval to operate an exchange according to Article 1 of the Exchange Act. These list of relevant criteria has been agreed on by all Exchange Supervisory Authorities in Germany.

Sincerely

(Hiestermann)

Criteria for the Approval of Exchanges to be Established Pursuant to the German Stock Exchange Act (*Börsengesetz* – "BörsG") and the German Securities Trading Act (*Wertpapierhandelsgesetz* – "WpHG")

1. Requirements regarding the Exchange Operator

   a) Stability of the Exchange Operator in terms of organisation, human resources and financial resources to sustain on-going exchange operations

   b) Compliance with requirements by holders of material interests in the Exchange Operator (section 3(2), sentence 1 of the BörsG)

   c) Presentation of a business plan

2. Requirements regarding exchange operations

   a) Sufficient financial resources, human resources and equipment to safeguard the establishment and the operation of the exchange, as well as the appropriate development of exchange operations (taking into account the type and scope of exchange operations, and the risks involved)

   b) Establishment of the required exchange entities (Exchange Council, Exchange Management, Trading Surveillance Office, Admission Board)

   c) Rules and Regulations (comprising Exchange Rules and Conditions for Exchange Trading) covering the admission of financial instruments and trading participants, the orderly conduct of exchange trading and orderly settlement of exchange trades based on objective criteria, as well as related surveillance and monitoring duties; where appropriate, such Rules and Regulations shall also cover the orderly conduct of clearing operations and financial settlement of exchange trades, including a scheme to protect the exchange against the financial impact of default by clearing members (clearing agency / clearing house)

   d) Technical infrastructure satisfying functional requirements, including emergency procedures for service disruptions or system failure

   e) Compliance with requirements where third parties have been entrusted with the performance of functions and duties which are material for on-going exchange operations (section 1(3) of the BörsG)

   f) Reliability and professional skills of the members of the Exchange Management

Contents of the Business Plan

1. Structure of the plan:

   a) Object of the company acting in the capacity of the Exchange Operator and business divisions of the exchange

   b) Capitalisation, organisation and human resources of the Exchange Operator

   c) Shareholder structure (including associated voting rights) of the Exchange Operator

   d) Financial planning for the first three years of exchange operations

   e) Organisational structure of, and human resources and equipment available to the exchange

   f) Market model, trading and settlement structure and technical equipment; where appropriate, including the structure of clearing and financial settlement procedures and of the financial protection scheme

   g) Market structure and major groups of trading participants

   h) Internal control systems of the exchange

   i) Reliability and professional skills of the proposed members of Exchange Management

   j) Safeguarding of confidentiality duties

2. Documentation accompanying the business plan

   k) Draft Exchange Rules and Conditions for Exchange Trading

   l) Memorandum and Articles of Association, and financial planning of the Exchange Operator

   m) Profit transfer agreements, controlling agreements and other inter-company agreements; as well as agreements entered into by shareholders which have an impact on the Exchange Operator, or on the exchange

   n) Agreements governing the outsourcing of functions and duties which are material for on-going exchange operations to third parties

   o) Proposed composition of the Preliminary Exchange Council

The business plan must contain evidence regarding the sustained compliance with the requirements for exchange operations, pursuant to the Stock Exchange Act and the Securities Trading Act, giving details as to how such compliance will be ascertained. Approval will be granted subject to the proviso that notification shall be given to the exchange supervisory authority, without delay, in the event of any amendments to the business plan.

ANSWERS TO SUBMITTED QUESTIONS

GOVERNANCE ISSUES

Exchange governance is a hot topic these days. Please describe for the committee your understanding of the governance structure described in the Eurex US application. In terms of its Board and its executives, how will the Eurex US structure compare to other governance structures at U.S. futures exchanges?

In the event of a market emergency, what steps do you expect Eurex US to follow?

As submitted to the Commission, Eurex US bylaws (in the section titled "Number of Directors") state that the exchange will have only one director and that the director shall be Mike McErlean. Please describe what you expect the makeup of the Board ultimately to be?

Of its Board members (once more are added), how many will be independent of other ties to the business of the exchange.

What compliance committees will be established by Eurex US and how will they function? How does this structure in the Eurex US plan compare to the norm in existing U.S. futures exchange?

The Board of Directors of U.S. Futures Exchange, L.L.C. (USFE) will be constituted in accordance with the Limited Liability Company Agreement and Bylaws (Bylaws). Pursuant to section 5.2(a) of the Bylaws, there is currently an initial member of the Board of Directors, Mr. Michael McErlean. Additional Directors will be appointed prior to the launch of trading.

The Board of Directors of USFE will be selected by its shareholders at a USFE shareholders meeting. Currently, USFE has one shareholder, U.S. Exchange Holdings, Inc., a Delaware corporation wholly owned by Eurex Frankfurt AG. Before the USFE shareholders meeting, at which the new USFE Board members will be elected, the Board of Directors of U.S. Exchange Holdings will meet and decide whom it will elect to the USFE Board of Directors. All of the Directors so elected will meet the statutory requirements regarding the fitness of directors of exchanges, and a majority will be U.S. citizens or located in the United States.

When expanded, the Board will be composed of 12 Directors. Of these, at least six will be drawn from Exchange members and are intended to represent different general groups of members, such as brokers, arbitrage firms, institutional investors and independent clearers. The remaining six Directors may include officials, employees or members of the boards of USFE's parent companies.

USFE's Compliance Department shall be authorized to conduct and to oversee surveillance, investigation and rule enforcement activities. The Chief of the Compliance Department shall be in charge of the Compliance Department. The personnel of the Compliance Department may not operate under the direction or control of a Member.

The Disciplinary Committee of the exchange shall be authorized to determine whether violations of the Bylaws or the exchange's Rules have been committed, to accept offers of settlement, and to set and impose appropriate penalties. The Disciplinary Committee shall consist of such officers or employees of the exchange appointed to the Disciplinary Committee by the Chief Executive Officer. No employee of the Compliance Department of the exchange may serve on the Disciplinary Committee.

RECIPROCITY

Are U.S. exchanges able to do in Germany what Eurex proposes to do here? Please comment with regard to reciprocity issues. If a U.S. entity applied to open an exchange in Germany tomorrow, could it have a reasonable expectation of getting a decision from German regulators within 6 months?

U.S. exchanges are able to do in Germany what Eurex proposes to do here, and have already done so. There are no restrictions on foreign ownership of exchanges licensed in Germany. The licensing criteria applied by German regulators make no distinction based on non-German ownership and are, in fact, quite similar to the standards applied under U.S. law. German exchange regulators already have permitted Nasdaq to take control of the holding company of the Bremen stock exchange. Nasdaq acquired a 50% plus one ownership stake in the holding company, which was renamed NASDAQ Deutschland, while the exchange traded securities in competition with other German exchanges. Even if German exchange regulators were inclined to delay or deny an application, which we are not aware of, under the

European Union's Investment Services Directive a U.S. exchange could operate in Germany, using a license received from any of the 14 other member states of the European Union, without the need to obtain any German regulatory approval.

Written Testimony of
Terrence A. Duffy, Chairman,
Chicago Mercantile Exchange Inc.
to the
Committee on Agriculture
U.S. House of Representatives

Re: Application for Contract Market Designation of EUREX U.S.

November 6, 2003

Thank you Chairman Goodlatte, Chairman Moran, and members of the Committee. As Chairman of the Board of Directors, I appreciate the opportunity to testify on behalf of Chicago Mercantile Exchange Inc. Our innovations during the three decades since we invented financial futures have spawned a vibrant, dynamic and highly competitive industry for managing risk. Today, CME is the largest futures exchange in the United States and will soon be the largest clearing organization in the world for futures and options on futures. We are the only demutualized and publicly traded financial exchange in the United States. We are regulated by the Commodity Futures Trading Commission ("CFTC"); we also comply with the disclosure and transparency requirements applicable to public companies under the Federal securities laws and NYSE listing standards. Our corporate structure, governance standards, compensation practices, business model and market practices are all publicly disclosed.

We employ 1,200 persons directly in the U.S. and, together with the Chicago Board of Trade, we account for nearly 150,000 jobs in the Chicago metropolitan area. We offer extensive trading and clearing facilities for futures and options on futures in interest rates, stock indexes, foreign exchange, commodities and other derivatives. We offer these products for trading via both our open outcry and our GLOBEX® electronic trading platforms. Nearly one-half of all trading activity in our products is fully automated, reflecting the extraordinary compound annual growth rate of 112% in GLOBEX volume from 1997-2002. This growth has been achieved despite fierce competition with foreign and domestic futures, options and securities exchanges and the over-the-counter derivatives market.

Each day, the CME Clearing House facilitates the transfer of about $1.5 billion per day in settlement payments, and we manage $29.6 billion in collateral deposits. Earlier this year, CME entered into an important clearing services agreement with the Chicago Board of Trade that will save end users of our markets approximately $1.4 billion in performance bond collateral and provide more than $200 million in capital savings for our valued clearing member partners. All of these innovations and changes have strengthened our competitive position and ability to provide the most efficient risk management and asset allocation services to institutions, corporations and individuals around the globe.

I thank the Committee for recognizing the importance of this issue and for your willingness to promptly devote your time and attention to this matter. I want to begin by reiterating my praise for the Commodity Futures Trading Commission and Chairman Newsome. When I testified before the Subcommittee earlier this year, I stated:

> "In the judgment of the CME, the Commodity Futures Modernization Act of 2000 (CFMA) represents successful landmark legislation that materially and beneficially reformed some of the nation's most important financial markets. Our futures markets are substantially stronger and more vibrant today as the direct result of Congress' enactment of the CFMA and, equally importantly, the CFTC's judicious and deliberate implementation of those reforms. Innovation has been encouraged and made less costly and more rewarding. The time between conception of a new product or trading system and its implementation has gone from years to days. Today, the vast majority of CME's investment in innovation is for improvement and testing rather than paperwork and bureaucratic review."

Chicago Mercantile Exchange Inc. welcomes this opportunity to offer its view of the question of whether the application for contract market designation (the "Application")[1] filed by U.S. Futures Exchange, L.L.C. ("EUREX U.S."), Eurex's wholly owned U.S. subsidiary, is complete. I am here today because I believe Congress never intended to allow new exchanges to commence operations in the U.S. without explaining how they will regulate activity in their markets, how they will assure safe and sound clearing and settlement of transactions, why it is appropriate to offer tens of millions of dollars in rebates to fiduciary intermediaries to move order flow from an established liquid market to another new market and how U.S. authorities can affect the true controlling persons of exchanges that may be controlled by persons and organizations resident outside of the United States. The questions that I raise here today are not founded on objections to entry by a foreign competitor. At the end of the day, I hope to convince you and the Commission that these important issues have been camouflaged by an empty application that needs to be completed before final Commission action.

Overview

On September 16, 2003, Eurex's wholly owned U.S. subsidiary submitted its application for contract market designation and asked for approval within 60 days—without formal Commission review. The Commission announced that it intended to give Eurex fast track treatment, as requested. EUREX U.S.'s evident plan was to secure CFTC designation for its empty shell of an exchange, and thereafter to "self-certify" the rules that implement its true business plan in a manner that would escape Commission

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[1] As used herein, the term "Application" includes all the publicly available exhibits that EUREX U.S. 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 EUREX U.S.'s Rules.

review and approval. This tactic precludes scrutiny from the Commission and other interested parties. We made a clear case that the fast track process was not appropriate, and the Commission responded appropriately.

EUREX U.S.'s application is an empty shell. It omits important facts concerning how it will handle critical regulatory, clearing, settlement and financial responsibilities and the contracts it will trade. These omissions were intentional. EUREX U.S. knows the answers; it is circulating marketing materials to selected market participants that define some of these processes. It omitted reference to its business plans because it did not want to defend these practices as a condition of contract market designation.

Novel and objectionable issues pervade Eurex's skeletal application. All of Eurex's critical clearing, operational and regulatory functions are outsourced to third parties, one of which, the parent company, is based in Germany and not subject to the Act, and another, NFA, is not authorized or qualified to perform the required functions. Eurex intends to offer an internationally linked clearing system that permits customers to transfer positions between Germany and the United States. Such arrangements also present significant potential cross-border bankruptcy and other legal risks which have not been clearly delineated for market users and regulators. EUREX U.S.'s application purposefully omits reference to any of these planned business and operational practices. We believe that this Application should be remitted to Eurex for completion prior to any further consideration by the Commission.

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 pubic 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.

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 abrupt about-face on a number of the documents shortly after CME's September 16, 2003, Freedom of Information Act ("FOIA") request to release those documents.

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

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 will perform such functions without any descriptions of the specific resources that they will bring to bear, their experience and their skill, does not fulfill the designation criteria.

CME believes that having the opportunity to review all the documentation relating to the Application is critical to allowing CME and other interested parties to make an 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. At a minimum, we urge the Commission to require EUREX U.S. to supplement or amend the 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.

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 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.

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"), EUREX U.S. announced its intention to "Promote Liquidity Through [a] Public Market Making Scheme."[5] The scheme includes a payment for order flow program, in which EUREX U.S. seeks to entice its brokers to direct customer business to EUREX U.S. by offering a chance at a large pay off. The Report provides that a "revenue rebate plan for the US Treasury derivative products will run for the first two years of Eurex US operations[,]" providing

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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."

[5] *See* Report at 9. The relevant pages of the Report are attached as Exhibit A.

"50% of trading fee revenues on the first year of operation [and] 25% of trading fee revenues on the second year of operation."[6] 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."[7]

EUREX U.S.'s proposed plan to buy order flow is improper and 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. For example, 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."[8]

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 boilerplate 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

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[6] *Id.* at 10.

[7] *Id.*

[8] Letter from Harvey Pitt, Chairman, SEC, to Meyer Frucher, Chairman, Philadelphia Stock Exchange ("Phlx"), (January 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 (October 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 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 (February 3, 2003). To date, the SEC has not acted on the Phlx's petition.

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.

As proposed, EUREX U.S.'s program is a bold implementation of the worst 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 encourage brokers to blindly funnel customer orders to EUREX U.S. in hopes of scoring a large rebate. In promoting the interests of brokers, 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.)

The Application, premised upon the payment for order flow program, is 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 opinions of the controversial practice.[9]

Market Surveillance Concerns and Deficiencies

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). NFA's Board of Directors has not yet been presented with nor considered the agreement.

We know that the agreement calls for NFA to administer and enforce EUREX U.S's trade practice and anti-manipulation rules. NFA's Articles of Incorporation preclude it from performing such services for a designated contract market. Article III, Section 2(a) sets forth certain activities that are prohibited, such as the following: "No NFA requirement shall purport to govern or otherwise regulate the specific conduct of a Member or Associate if such conduct is governed or regulated by the requirements of a contract market..." Section 2(b) further provides that:

> (b) Prohibition Upon Adoption of Certain Rules.
>
> NFA shall not adopt, *administer or enforce* upon any Member or Associate a rule, standard, requirement or procedure which purports to govern or otherwise regulate any of the following:
> **********

[9] 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 (October 19, 2000).

(iii) The rights, privileges, duties or responsibilities of membership in any contract market or clearing organization.
(iv) The content, interpretation, administration or enforcement of any rule, standard, requirement or procedure of a contract market or clearing organization.
(v) The conduct of business or other activities on the trading floor of a contract market.
(vi) The terms or conditions of any futures contract.(emphasis supplied)

NFA's organizing documents reinforce the conclusion that the Eurex Regulatory Service Agreement exceeds the purposes of NFA. For example, the meeting minutes of NFA's Organizing Committee, dated October 12, 1976, note that compliance and surveillance activities "[s]hould not reach floor brokers or Exchange activities." Further, in a letter to the Acting General Counsel of the Commodity Futures Trading Commission ("CFTC"), dated February 24, 1977, counsel for NFA assured the CFTC that "[i]t is not the intention or objective of the Organizing Committee to shift any of [the duties imposed on contract markets by Section 5 and 5a of the Commodity Exchange Act] from the contract markets to NFA. On the contrary, great care has been exercised to assure that section 5 and section 5a responsibilities remain with the exchanges. An examination of the initial functions to be performed by the NFA shows that no mandatory duty of a contract market is involved."

Further, in its Points of Agreement contained in its Handbook of 1977, NFA agreed that it "should regulate in all respects the industry segments not subject to exchange regulation...." The intent of the Organizing Committee was to "close any existing regulatory gaps that exist with respect to persons and entities that are not subject to exchange self-regulation" not overlap or pre-empt exchange rules. However, the Organizing Committee did not preclude regulation of the exchanges at some future point in time. Instead, the Points of Agreement state that while "NFA will not undertake initially any other regulatory function affecting activities of persons or entities on contract markets [the Articles may] be subject to amendment so that new and different functions can be assumed by the NFA in the future when there is clear support for doing so...."

However, no such amendment has been implemented by the Board. Currently, the plain language of Article III prohibits NFA from performing the services contemplated by the contract with EUREX U.S. In NFA's 1979 brochure, it clearly states that "NFA will not regulate any matters within the exchanges' special expertise, such as floor practices, contract terms, margin requirements, market surveillance, the rights or obligations of floor brokers, and capital requirements for clearing privileges." In addition, in a letter signed by Leo Melamed containing NFA's comments to the CFTC, dated November 6, 1978, Mr. Melamed stated that "the contract markets are not proposed for membership in the NFA as a means of policing the exchanges" nor to oversee the exchanges. In its Registration Statement dated March 16, 1981, it states that "[i]n accordance with NFA's policy of not regulating contract market matters, NFA will not bring disciplinary actions against a person where the specific conduct in question is covered by a contract market rule and the person is subject to the contract market's disciplinary jurisdiction for the conduct."

At a hearing before the CFTC on June 4, 1981, Mr. Melamed testified that NFA's purpose is "not to regulate the order flow once it hits the floor of an exchange but rather to regulate all that occurred before it does in fact. The dividing point becomes right there. It is the exchanges that take over at that point, the NFA previous to that." Mr. Melamed further testified that "it has always been our intention not to get involved with the floor brokers, or regulation, or rules of and for that community of members. The exchanges have done a thorough job in this area, and have an intricate set of rules, and a long history of regulation over floor brokers and the community on the floor, it is not the intention of NFA to ever overstep that divisional line, and we will not." Clearly, providing the services described in the proposed contract with EUREX U.S. at this time would violate NFA's Articles.

NFA's Executive Committee's response to this explanation does not even come close to passing the "red face test." In its revelatory, self-justifying letter to the Commission, NFA first admits that: "NFA will conduct trade practice and market surveillance (TPMS) on behalf of Eurex U.S." NFA boasts that it has absolute power to control its investigations. It goes on to explain that, as the appointed agent of EUREX U.S., NFA will have power to compel members to produce documents and to cooperate with its investigations. It concedes that NFA will prosecute alleged violations. But NFA contends that its actions do not constitute "administration or enforcement" of the disciplinary rules because: "NFA is merely a contractual service provider and will not make any decisions on behalf of Eurex U.S. NFA will investigate potential rule violations and will make its enforcement attorneys available to prosecute enforcement cases on an hourly basis, just as any hired law firm would do, but Eurex U.S. will determine whether to initiate a formal investigation, whether to issue a complaint, and how to resolve a charged matter." ***If NFA is not administering and enforcing the rules, no one is.*** EUREX U.S. does not even have its own disciplinary committees. The fact that NFA provides the services "under contract" does not change the nature of the services. NFA's agreement is *ultra vires.*

In addition to its lack of corporate authority, NFA lacks the resources and experience to perform the required regulatory services. EUREX U.S.'s business plan is to link its trading and clearing with its parent, Eurex Deutschland. Linked trading and clearing requires a single surveillance and compliance system or closely coordinated separate systems that seamlessly integrate the information from both trading and clearing systems. Otherwise, inexplicable changes in open interest, manipulative wash trades, and any number of abusive trading practices that affects EUREX U.S. and other U.S. futures markets can be executed and cleared on the facilities of Eurex and be beyond the regulatory reach of NFA. NFA has not demonstrated that it has the capacity to regulate effectively and prevent market manipulation in the international context.

Even if EUREX U.S.'s business plan did not create these intractable problems – if EUREX U.S. were merely a stand-alone U.S. exchange – NFA does not have the human resources to perform the outsourced regulatory services at the level required by the CEA's Core Principles. NFA has implied that its staff includes a sufficient number of

well-trained investigators and analysts to service EUREX U.S.'s regulatory needs. NFA's trade practice market surveillance area ("TPMS") consists of two full-time staff and a manager who has other responsibilities in addition to TPMS. These people are already working on other outsourcing projects and are hard-pressed to do an adequate job on the small projects to which they are already assigned. 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."10

NFA claims to have six individuals cross-trained and ready to go to work in these areas. However, four of those individuals are auditors who have never done trade practice or market surveillance work and who appear to be fully employed. NFA has no dedicated IT resources within TPMS, and its computer hardware and tools are limited. Without skilled, experienced regulatory staff, NFA cannot possibly be an effective regulatory resource as required by the Act.

NFA's plan to perform trade practice surveillance for EUREX U.S. depends on the use of its automated system. NFA's plan assumes that all or substantially all of EUREX U.S.'s trading will be executed on its electronic system and that NFA will be able to base its review on trustworthy, electronically generated trade data. It does not appear that NFA has understood or accounted for the manner in which Eurex will conduct its option trading. The CBOT's comment letter on EUREX U.S.'s application makes it clear that the options on futures market is conducted by means of a call around market that does not leave an indelible, accurate audit trail.

By comparison, at least with respect to futures options trading, Eurex Deutschland relies primarily on a "call-around" market, resulting in "OTC" trading of a vast majority of such options transactions, though the exchange's alternative execution facilities. Therefore, Eurex Deutschland's options markets are quite different from the transparent options markets that have historically protected U.S. market participants. More specifically, those transactions that are executed through the alternative execution facilities (OTC transactions) are the primary driving force behind options volume on Eurex Deutschland as highlighted below:

Volume figures for 2003 (January-August)

Euro Schatz:	Futures 77,637,697 (Basis Trades 1,797,378, 2.3%)
	Options 8,766,545 (OTC 8,561,349, 97.7%)
Euro Bobl:	Futures 102,006,518 (Basis Trades 4,363,548, 4.2%)
	Options 6,869,541 (OTC 6,594,179, 96%)
Euro Bund:	Futures 169,704,106 (Basis Trades 6,746,675, 3.98%)
	Options 20,163,112 (OTC 16,898,721, 83.8%)

(Source: Eurex August 2003 Monthly Statistics)

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

NFA has no means to monitor those OTC transactions for compliance with EUREX U.S.'s rules.

Avoidance of Treasury Department Review

The application is so devoid of information it fails even to specify the contracts that will be traded, although EUREX U.S. is telling its prospective customers, that a full suite of U.S. Treasury products will be listed on February 4, 2003. This omission from the application appears to be an effort to exploit an apparent loophole in the CEA and avoid Treasury Department scrutiny of its planned Treasury Security Futures contracts.

The Commodity Exchange Act requires the CFTC to give Treasury and other interested agencies and departments an opportunity to comment on certain futures contracts. CEA Section 2(a)(8)(b)(ii) provides in relevant part:

> "(ii) When a board of trade applies for designation or registration as a contract market or derivatives transaction execution facility involving transactions for future delivery of any security issued or guaranteed by the United States or any agency thereof, the Commission shall promptly deliver a copy of such application to the Department of the Treasury and the Board of Governors of the Federal Reserve System. The Commission may not designate or register a board of trade as a contract market or derivatives transaction execution facility based on such application until forty-five days after the date the Commission delivers the application to such agencies or until the Commission receives comments from each of such agencies on the application, whichever period is shorter. . . . [T]he Commission shall take into consideration all comments it receives from the Department of the Treasury and the Board of Governors of the Federal Reserve System and shall consider the effect that any such designation, registration, suspension, revocation, or action may have on the debt financing requirements of the United States Government and the continued efficiency and integrity of the underlying market for government securities."

This provision was added by the Futures Trading Act of 1978. The stated purpose was to insure that the Treasury Department had a fair chance to assess the impact of the new market on "the debt financing requirements of the United States Government and the continued efficiency and integrity of the underlying market for government securities." (Senate Report No. 95-850, May 15, 1978, Letter from The Deputy Secretary of the Treasury, Robert Carswell, to the Honorable Patrick J. Leahy (April 13, 1978) at 46.) The legislative history of this section demonstrates the importance with which the Treasury Department and the administration regarded this provision.

Section 2(a)(8)(b)(ii) was amended by the Commodity Futures Modernization Act of 2000 (Appendix E of P.L.106-554, 114 Stat. 2763) by adding "or derivatives transaction execution facility" after "contract market." CFMA also changed the process that a designated contract market was required to follow in order to list new futures

contracts. CFMA permits an existing designated contract market to list a new contract based on Treasury Securities by providing to the Commission and the Secretary of the Treasury a written certification that the new contract complies with this chapter. Self certification under this provision may create an opportunity to obviate Treasury's power to review and comment as provided in Section 2(a). Section 5c provides in relevant part:

> Sec. 5c. COMMON PROVISIONS APPLICABLE TO REGISTERED ENTITIES
> (c) NEW CONTRACTS, NEW RULES, AND RULE AMENDMENTS.-
> (1) IN GENERAL. - Subject to paragraph (2), a registered entity may elect to list for trading or accept for clearing any new contract or other instrument, or may elect to approve and implement any new rule or rule amendment, by providing to the Commission (and the Secretary of the Treasury, in the case of a contract of sale of a government security for future delivery (or option on such a contract) or a rule or rule amendment specifically related to such a contract) a written certification that the new contract or instrument or clearing of the new contract or instrument, new rule, or rule amendment complies with this chapter (including regulations under this chapter).

This addition made by CFMA creates an apparent loophole that permits a new exchange, intent upon trading Treasury Security futures, to avoid scrutiny from the Treasury. The legislative history of this provision does not explain whether the general provisions of Section 5c were intended to supersede the specific provisions of Section 2(a)(8)(b)(ii), which was amended and preserved by the same Act. We have reviewed the relevant committee reports and testimony and have not found an explanation. It is possible to reconcile the two provisions if the requirement that a registered entity certify that the new contract "complies with this chapter" means that a new contract based on a Treasury Security was submitted to the Treasury Department for review in accordance with Section 2.

EUREX U.S. intends to avoid Section 2(a)(8)(b)(ii) and exploit this lacuna by proceeding with a designation application that includes no information respecting the contracts it intends to trade. EUREX U.S.'s application omits specifications for the Treasury Security Contracts it intends to trade: yet it knows and has told all of its potential customers that on February 1, 2004 it will list the full suite of U.S. Treasury Securities. EUREX U.S. has also told its prospective customers that it intends to permit the resulting Treasury Security futures contracts to be sent to Germany for clearing by an unregulated entity.

There are two ways to prevent this obvious misuse of the CFMA. First and most directly, the CFTC, after consultation with Treasury, could reject the application as incomplete and require that EUREX U.S. resubmit with full disclosure of: the contracts it intends to trade; its arrangements for international trading linkages; the means by which it intends to provide domestic clearing for those contracts; and the international clearing linkages that it intends to implement. If the CFTC requires a complete application, it will be required to submit all Treasury related security futures contracts to the Treasury Department for review and comment under Section 2(a)(8)(b)(ii).

Second, the CFTC could be asked to commit to condition any contract market approval on a requirement that EUREX U.S. refrain from self-certifying any futures contract based on any Treasury Security without following all of the procedures set forth in Section 2.

Important Matters Not Addressed in the Rules

We have separately provided the Commission with our preliminary analysis of the defects in EUREX U.S.'s proposed Rules. In addition to those defects, however, the proposed 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.[11]

Clearing and Risk Management Deficiencies

A clearing and settlement system requires logical, comprehensive and detailed procedures. As discussed more fully below, the Rules fail to spell out how many of the procedures would be performed, in contravention of Designation Criterion 5 of the Act.[12]

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.

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[11] 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)."

[12] 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."

The alleged agreement has been submitted to the CFTC but has not been made available to the public, despite 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,[13] each 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.[14] 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.

Deficient Risk Management Rules

Several of EUREX U.S.'s rules do not adequately ensure the financial integrity of transactions entered through the proposed Trading System. They include:

(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.

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[13] 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). . . ."

[14] *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).

(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.

Recordkeeping Deficiencies.

In an effort to prevent customer and market abuses, the Act requires exchanges to establish and enforce strict recordkeeping requirements.[15] The Application, however, is rife with recordkeeping 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.[16] 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.

Operational Concerns.

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[15] *See* Core Principle 10 of the Act, which 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."

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

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 and Deutsche Börse AG). Specifically, EUREX U.S. has allegedly entered into two outsourcing agreements: 1) a General Services Agreement with Eurex; and 2) a Service Level Agreement between Deutsche Börse AG and Eurex. 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, the Exchange 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 Börse AG and Eurex do not satisfy this requirement, thus making the Application fatally flawed.

Conclusion

If approved, Eurex will become a designated "black box" market whose critical regulatory, operational and clearing functions are outsourced to third parties, unknown to the CFTC and the industry and potentially outside the jurisdictional reach of the Commission when the time comes to act. There is no reason to delay approval of complete and sound applications of new exchanges. There is every reason to ensure a proper process is followed for new exchanges that will offer products and services to U.S. investors.

We urge that the Commission disapprove the proposal as filed. 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.

DNVec

Letter from CME attorney upon application that CME made to place one terminal in Germany. The process took well over a year to place ***one*** terminal in the country.

Rogers & Wells

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FACSIMILE TRANSMISSION

TO	Mr. Carl Royal	COMPANY	Chicago Mercantile Exchange
RECIPIENT FAX	00 1 312 930 33 23	RECIPIENT PHONE	

FROM	Alexander Marquardt	DATE	July 9, 1999
SENDER PHONE	33 1 44 09 46 00	PAGES (W/COVER)	2
E-MAIL	marquara@rw.com		

MESSAGE — FOR FAX TRANSMISSION PROBLEMS, PLEASE CALL (33-1) 44 09 46 00

Re: GLOBEX - Germany

Dear Carl:

I finally managed to reach Mr. Daum, the Hesse regulator, today. He was quite embarrassed and profusely apologized but said he had to inform me that the matter had become politicized to an extent that the level of tension is approaching that of a trade war. Accordingly, yielding to political pressure (he mentioned EUREX by name), he is obliged to further scrutinize our application.

He needs further information on the following two subjects:

1. The relationship between the CME and SBF. I explained to him that there is a licence for the use of NSC. He requested written confirmation and unspecified further explanation of the relationship. He did not ask for a copy of the licencing agreement, and I would suggest that we only send him a summary description of the agreement.

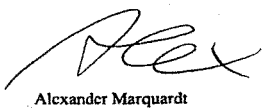
2. A list of the contracts traded on the system.

I requested that he send me written confirmation of this request for further information, which he said he would do next week.

I also stated that, while we would, of course, comply with his information request, we continue to be of the view that the installation and operation of GLOBEX terminals in the State of Hesse is not subject to

prior government authorization. His response was that, in principle, nothing has changed as a result of his request for further information, but that, due to the above-mentioned political pressure, he was regrettably obliged to further scrutinize our application. He apologized for this unfortunate delay.

With best regards.



Alexander Marquardt

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October 2, 2003

Approval for Operating Derivatives Exchange in Germany

Dear Terry:

With reference to your e-mail of September 30, 2003, the following summarizes the approval requirements for operating a derivatives exchange in Germany.

There are no specific rules or regulations addressing the requirements or procedure for obtaining a license to operate an exchange in Germany. The Exchange Act provides that the establishment of an exchange requires an approval by the supervisory authority of the state where the exchange will operate; any such approval can be withdrawn by such authority. It does not mention nor refer to any of the conditions which must be fulfilled in order to qualify for an approval.

In the absence of statutory provisions or regulations, the – scarce – legal writing dealing with this issue is unanimous in that the supervisory authorities have - fairly broad - discretion in determining wether or not any potential applicant is suited for operating an exchange and, perhaps more importantly, whether it is necessary or appropriate to have an additional exchange operating on their territory. It may even be questionable whether the administrative courts would take legal action brought by an applicant in view of a rejection by the supervisory authorities of a request to operate an exchange. In case of legal actions deemed "receivable" by the court, the court would have to determine whether or not the decision in question was based on inappropriate considerations. It is thought that the grants for a court to accept or reject a potential application may include economic and "structural" considerations, such as the economical relevance of an exchange for the state and its infrastructure and a policy not to have trading volumes "diluted" as a consequence of having too many exchanges operating on the state's territory in Germany.

As discussed, the above-described legal premises for approvals by the state authorities make it very difficult to determine in any given case whether there is a "legal right" of an entity to operate an exchange in any one of the German states, and it is hard to imagine that a denial of an approval by a state's supervisory authority based on other than purely nationalistic or protectionist grounds (and there are quite a few conceivable such grounds such as the policy of concentrating trading volumes at one exchange) can ever be successfully challenged in court.

Please let me know if there are any questions. I will be traveling until October 13 inclusive, and if there are any questions in the meantime, please contact Simone Jorden, or call me at my mobile (+49-171-747-1946).

Best regards,

Rainer

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Testimony of Donald R. Wilson, Jr., Chief Executive Officer and Founder of DRW Holdings, LLC Before the House Agriculture Committee, November 6, 2003

Mr. Chairman and Members of the Committee, I would like to thank you for the opportunity to submit testimony expressing my concerns regarding the application of U.S. Futures Exchange, LLC ("Eurex US"). The focus of my testimony is on the issues of transparency, payment for order flow, internalization of orders and general fairness. While my comments relate primarily to options, I will also address certain aspects of futures. My concerns are based on the likelihood that Eurex US will promote a market structure similar to the one Eurex has fostered in Europe, where there is a fragmented market and a complete lack of transparency.

I. Background

A. About DRW

I am the founder and Chief Executive Officer of DRW Holdings, LLC ("DRW"). Through its operating subsidiaries, DRW engages in proprietary trading across a wide range of markets. I have personally traded options in many different markets for fourteen years. My trading has occurred both in Europe and the United States and has transpired both on and off exchange trading floors. During this period, I have seen the development and deterioration of several different markets and exchanges.

DRW is an active participant in options on fixed income futures throughout the United States and Europe. The scope of our involvement includes Eurodollars traded on the Chicago Mercantile Exchange, U.S. Treasury products traded on the Chicago Board of Trade ("CBOT"), Euribor traded on the London International Financial Futures and Options Exchange, and European government bonds (Bund, Bobl and Schatz) traded on Eurex Deutschland ("Eurex Europe"). Through the third quarter of this year, our market shares are: Euribor options 22%; Bund, Bobl and Schatz options 16%; Eurodollar options 17%; and Treasury options 7%. I believe these levels of activity make DRW the largest proprietary trader of options on futures in the world. DRW is also an active participant in the underlying futures markets and has been a significant participant on Eurex Europe since the inception of the exchange.

B. About Eurex Europe

Although Eurex Europe is technically an electronic exchange, options listed on it do not, for the most part, trade electronically. In fact, through the first nine months of 2003, only 10% of the Bund, Bobl and Schatz options traded electronically. The other 90% of the options traded as block transactions either in the "call around market" or through internalization of orders by brokers. A block trade is a privately negotiated futures or options transaction executed apart from the public auction market. Futures transactions may go through the call around market where the transaction is unusually large or the futures strategy is complex, involving more than one futures contract.

The call around market in Eurex Europe products works as follows. A broker that has received an executable order from a customer (either in futures, options or a combination) will call one or more market makers to obtain a price at which the order could trade. The broker then selects one or more market makers with which to cross the order. Sometime thereafter, the broker will notify Eurex Europe that a block trade has occurred. By transacting in this manner, the broker charges brokerage to both the customer and to participating market makers, in effect earning double brokerage.

II. Substantive Issues

A. Payment for Order Flow to Brokers and Internalization of Orders

The call around market described above creates a form of payment for order flow, such that market makers must pay to have brokers trade with them. This process raises several concerns:

1. There is no centralized price discovery mechanism. The result is a fragmented market. Whether on a trading floor or on a computer screen available to market participants, a centralized place for price discovery leads to a transparent market. On Eurex Europe, market participants are unable to make informed decisions as they possess only a portion of the available information.
2. Frequently trades on Eurex Europe are executed in the morning and are not reported to the exchange until the end of the day. This "no tape" environment further precludes market transparency. Market participants are not only unaware of transactions on a timely basis, but it becomes increasingly difficult, if not impossible, to scrutinize whether trades were done at fair prices.
3. The market makers, from whom the liquidity in any market derives, must pay brokerage to the brokers. This is mandated payment for order flow in that a market maker who refuses to pay brokerage will no longer get calls from brokers and will be precluded from participating. This form of payment for order flow increases the transaction costs of the market makers, and recent experience has shown this increase to be material. The market makers pass this increase along to the customers by quoting a wider bid-ask spread. The result is a less efficient marketplace.
4. The brokers have a conflict of interest. The worse the execution by the brokers, the more market makers are willing to pay in brokerage, ultimately hurting customers.

There is another mechanism by which an order can be executed on Eurex Europe. The broker can, rather than selling an order to market makers in the call around market, internalize the customer's order by taking the other side of it. In this case, the broker clearly has a conflict. The worse the level of execution, the more profit for the broker. On futures exchanges in the United States, this practice is generally prohibited. On Eurex Europe, it is oddly encouraged.

The well-developed call around market and the practice of internalization of orders both result directly from Eurex Europe's rules relating to block trades. The block threshold, i.e. the minimum number of contracts to qualify for a block trade, for Bund, Bobl and Schatz options is 50 contracts per trade. Almost all orders are greater than 50 contracts. Therefore, almost all orders are eligible to be traded as blocks and can go the way of the call around market or be internalized by the brokers.

Eurex US's proposed rules set the block threshold at 50 contracts per trade for Bund, Bobl and Schatz options traded on Eurex US, and 2,500 contracts per trade for Treasury options. Many strategies in Treasury options contain multiple options. For example, a butterfly spread, a common strategy, contains four options per spread, so that an order for a butterfly would be block-eligible if the quantity of the order is for a minimum of 626 butterflies. Currently, many orders in Treasury options on the CBOT options are greater than 2,500 contracts. Thus, if traded on Eurex US, a significant percentage of the total Treasury option volume would be block-eligible. In contrast, the CBOT does not permit block trading in any of its Treasury products (futures or options).

Block trading should be entirely prohibited. It is the primary enabling factor in the existence of the call around market and the internalization of orders. As discussed above, these practices are likely to result in fragmented markets lacking in transparency. Further, brokers will have conflicts of interest. Brokers will be incentivized to route orders to Eurex US rather than to the CBOT as they will be able to either extract payment for order flow or internalize their orders. It is also my concern that Eurex US will lower its block threshold requirements shortly after launch, and these undesired practices will become even more widespread.

B. Cross Trades

Even if block trades were prohibited on Eurex US, the cross trade rule as proposed by Eurex US will facilitate the practices of payment for order flow and internalization. As proposed, a broker that has an executable order could, rather than execute it immediately, solicit an order from a market maker to take the other side of the customer order. Unlike a block in which a broker notifies the exchange of the transaction, in a cross trade, the broker first enters the market maker order electronically in the order book. The broker then waits the required time (15 seconds for options and 5 seconds for futures). Finally, the broker enters the customer order, thereby crossing the customer and market maker orders, thus replicating a block transaction. As an alternative, the broker can take the place of the market maker in this scenario, and thereby internalize the order flow.

C. Payment for Order Flow by Eurex US

Payment for order flow can also go from exchanges to brokers. This is another way in which brokers can be distracted from acting in the best interest of their customers. Eurex US has proposed to set aside certain of its revenues for distribution to its highest volume brokers. This is similar to the strategy that Eurex Europe used to wrest the Bund futures contract from the LIFFE exchange in 1997 and 1998. Around that time, Eurex Europe paid large sums of money to brokers in London with a goal to have them route all of their orders to Eurex Europe. This practice creates yet another conflict of interest for brokers.

Eurex US has also proposed certain incentive payments to liquidity providers. Liquidity providers generally trade for their own account, and, therefore, payments by exchanges to them do not create any conflicts of interest with other market participants.

III. Effect on Eurex Europe Volumes

There is evidence to suggest that the practices discussed above have hampered the growth of the fixed income option markets on Eurex Europe. When Bund futures and options were traded actively on LIFFE in 1995, in an open outcry setting, Bund Options traded 22% of the Bund futures volume. Through the third quarter of this year, fixed income options on Eurex Europe have traded only 10% of fixed income futures volume. As another comparison, CBOT Treasury options have traded 23% of futures volume year to date.

Additionally, from 1999 to the present, while the CBOT's Ten Year Note option volume grew at a rate of 44% per annum, Eurex Europe's Bund options grew at a rate of only 2.4%. This is further evidence that the call around market and internalization of orders inhibits use of the markets.

IV. Conclusion

Although competition among exchanges can be positive for futures markets and their users, it is important that certain issues be carefully considered before approving a new exchange. Paramount is whether an exchange will ultimately provide a centralized, transparent marketplace where prices can be efficiently discovered and all market participants are treated fairly. The Commodity Futures Trading Commission recognizes this by stating in its mission statement that:

> The agency protects market participants against manipulation, abusive trade practices and fraud. Through effective oversight and regulation, the CFTC enables the markets to serve better their important functions in the nation's economy providing a mechanism for price discovery and a means of offsetting price risk.

If Eurex US successfully recreates the market structure of its European counterpart, then these principles will be abandoned. All market participants will be disadvantaged by a lack of transparency. Payment for order flow and internalization of orders will not only create conflicts of interest, particularly towards customers, but will also lead to higher

transaction costs for all market participants. As a result, hedging activity will decline, resulting in greater earnings variance, and ultimately lower economic growth.

For the reasons discussed herein, I respectfully request that the 180-day statutory time period for reviewing the application of Eurex US be stopped and restarted only when Eurex US proposes a business model supporting rules and market practices that ensure an open and transparent marketplace.

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION, ET AL.

The Honorable Bob Goodlatte and the Honorable Charles Stenholm

Re: Eurex U.S. Application to become a Designated Contract Market

The undersigned trade associations represent all major participants in the U.S. capital markets. Our members include banks, securities firms, futures firms, Government securities dealers (including all primary dealers in U.S. Treasury securities authorized to transact directly with the Federal Reserve Bank of New York) and a broad range of professional financial intermediaries. Our members include the principal users of financial futures products, including the futures contracts on U.S. Treasury securities that are currently listed by the Chicago Board of Trade and proposed to be listed by the United States Futures Exchange (Eurex U.S.).

Financial futures contracts represent important risk management tools for our members, as well as for the thousands of institutions, companies, investors and individual customers our members serve. These products serve a critical role in enabling our members and others to provide interest rate sensitive products, such as mortgages and commercial loans, to consumers and businesses throughout all sectors of the United States economy.

We write today to alert the committee to our organizations' serious concerns regarding possible delay in the Commodity Futures Trading Commissions processing of the Eurex U.S. application for designation as a contract market. We believe that the CFTC has the expertise and resources to fully review the Eurex U.S. application in a timely manner. We urge this committee to encourage the CFTC to proceed expeditiously in acting on the application of Eurex U.S., as it has consistently done in the processing of other similar applications.

We are familiar with the Eurex U.S. application and have observed the commentary and media coverage attending the application. We wish to emphasize that we see no significant policy or regulatory issues raised by the application that would require or justify any legislative changes. Furthermore, we are aware of no issues that would preclude the prompt processing of the application.

As this committee is aware, the promotion of competition was a principal animating goal of the Commodity Futures Modernization Act of 2000 (CFMA). The CFMA modernized the regulatory framework for the U.S. futures markets, striking a more effective balance between Government oversight and private sector discipline. The CFMA was grounded in the understanding that market discipline can play an important role in protecting investors. Although not a substitute for regulation, the CFMA recognized that private sector discipline promotes efficiency and mitigates the need for overly prescriptive regulation. However, market discipline requires vigorous competition of the type that we believe Eurex U.S. is well positioned to potentially provide.

Designation of Eurex U.S. thus offers the potential for greater competition in the market for U.S. futures products. The entry of Eurex U.S. has the potential to enhance choice, and our members hope and expect that it will lead to increased efficiency, lower costs, a broader range of services and growth in the U.S. futures markets. Any undue delay in consideration of the Eurex U.S. application would put these important benefits at risk.

As the Committee on Agriculture played a crucial role in drafting the CFMA, our organizations welcome the committee's interest in the Eurex U.S. application as well as in other issues that arise out of enactment of the CFMA. This committee has an important role to play in ensuring that the promise of the CFMA is realized.

Accordingly, the undersigned organizations urge that this committee strongly encourage the CFTC to implement the CFMA's objectives by processing the Eurex U.S. application as expeditiously as possible.

Sincerely,

American Bankers Association, The Bond Market Association, The Financial Services Roundtable, Futures Industry Association, International Swaps and Derivatives Association, Securities Industry Association

cc: Hon. J. Dennis Hastert, Hon. Nancy Pelosi, Hon. Bill Frist, Hon. Thomas Daschle, Hon. John W. Snow, Hon. Alan Greenspan, Members of the House Agriculture Committee, Hon. James E. Newsome, Hon. Barbara Holum, Hon. Sharon Brown-Hruska, Hon. Walt Lukken

STATEMENT OF JOHN G. GAINE

Thank you Chairman Goodlatte and members of the committee. Managed Funds Association (MFA) appreciates the opportunity to submit its testimony regarding the application by U.S. Futures Exchange, L.L.C. (USFE) for designation as a contract market by the Commodity Futures Trading Commission (CFTC). MFA firmly supports the development of competitive markets and an expeditious, but thorough, review of USFE's application by the CFTC. The USFE's application has been strongly endorsed by the futures commission merchant community. Certain existing domestic futures exchanges, however, oppose USFE's request. It is important that the voice of the end-users of futures markets, contributes to this dialogue, and MFA hopes that this written testimony accomplishes that goal. Overall, we support the Chairman of the CFTC who stated in his testimony that the CFTC has been "committed to providing a level regulatory playing field for all existing and potential market participants, while being vigilant in its mission to foster markets free of fraud and manipulation."

By way of background, MFA, located in Washington, DC, is the only U.S.-based global membership organization dedicated to serving the needs of professionals worldwide that specialize in the alternative investment industry—privately and publicly managed futures funds, hedge funds, and funds of funds. MFA has approximately 700 members who represent a significant portion of the over $650 billion invested in these types of alternative investment vehicles around the world and who are, collectively, extremely active participants in the U.S. futures markets. MFA and its members favor the addition to the marketplace of any qualified contract market on the basis of fundamental principles of fairness and competition. More specifically, MFA supports the expeditious review of the USFE's application without compromising investor protection principles or market stability and surveillance mechanisms.

MFA believes that the designation of additional futures exchanges will foster an environment of healthy business rivalry, resulting in technological innovation. The array of products domestically available to U.S. investors is expected to increase significantly with USFE's introduction of certain European equity index futures and euro-denominated interest-rate products currently accessible only on overseas exchanges. Additionally, the liquidity of contracts already accessible in the U.S. markets should be enhanced with USFE's expected inclusion of U.S. interest-rate contracts in its product array.

Furthermore, we believe that the advent of USFE's involvement in the U.S. futures markets should promote the "responsible innovation and fair competition" among exchanges and market participants that the Commodity Futures Modernization Act of 2000 (the Act) envisioned as critical objectives. MFA believes this involvement would serve the public interest in multiple dimensions by materially improving the liquidity, efficiency, and product diversification of the U.S. futures markets. In addition, MFA views price competition among futures exchanges as a direct boost to the bottom line of the futures investing public, and allows exactly the sort of vigorous interplay among market participants and exchanges that the Act was designed to encourage. We are confident that the CFTC will evaluate U.S. Futures Exchange's application with these concepts in mind.

MFA believes these benefits to the investing public come at no cost from the standpoint of investor protection or the reliability of the operation of our nation's markets so long as the CFTC review concludes that adequate investor protection measures are in place. If approved by the CFTC, USFE will operate in Chicago and be completely subject to the jurisdiction of the CFTC and the full panoply of relevant U.S. law. USFE trades are to be settled at The Clearing Corporation, a highly credible domestic clearing organization with historical clearing relationships with the Chicago Board of Trade (CBOT), while USFE's execution system is expected to be an updated version of the trading platform developed by USFE's parent, Eurex, and deployed from 2000 to the present by CBOT. Moreover, Eurex itself is a globally respected exchange—in fact, the largest futures exchange (by volume of contracts) in the world—already well known to the CFTC in the context of the CFTC's granting of various forms of regulatory relief. Many U.S. market participants are already active traders on Eurex.

As the principal representatives of end-users of futures exchanges, MFA believes there is an overwhelming public policy argument to be made for the CFTC's expeditious review of the USFE's application for designation as a contract market. We believe that this will promote market efficiency and depth and avoid disadvantaging investors if the application process is delayed. MFA respectfully urges the committee to encourage the CFTC to act quickly in its review of the USFE application. We are confident that the CFTC will fulfill its pledge to "review the application, mindful of all the comments received, with an eye toward ensuring that all necessary stand-

ards are met, and that only sound, ethical business practices are allowed to exist in the U.S. marketplace."

MFA wishes to thank the committee for the opportunity to submit this testimony.