



New York  
Mercantile Exchange

NYMEX/COMEX. Two divisions, one marketplace

RECEIVED  
C.F.T.C.

RECEIVED  
C.F.T.C.

99-11  
~~scribble~~  
42

1999 MAY -3 P 2 41

MAY -3 AM 11 11

April 30, 1999<sup>T</sup>

RECEIVED  
C.F.T.C.

**VIA FACSIMILE, FEDERAL EXPRESS AND ELECTRONIC MAIL**

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

**COMMENT**

Re: Proposed Rules Concerning Access to Automated Foreign Boards of Trade 64 FR 14159 (March 23, 1999)

Dear Ms. Webb:

The New York Mercantile Exchange ("NYMEX" or the "Exchange") appreciates the opportunity to comment, on its own behalf and on behalf of its wholly-owned subsidiary, Commodity Exchange, Inc. ("COMEX"), on the Commodity Futures Trading Commission's ("CFTC" or the "Commission") proposed rules concerning access to automated foreign boards of trade ("Proposed Rules").

NYMEX is a not-for-profit corporation organized under the laws of the State of New York. It has been designated by the Commission as a contract market for the trading of numerous commodity futures and commodity futures option contracts. NYMEX is the largest exchange in the world for the trading of futures and option contracts based on physical commodities. Public investors in our markets include institutional and commercial producers, processors, marketers and users of energy and metals products.

As discussed in detail below, NYMEX believes that the Commission should modify its Proposed Rules to provide that its review of the comparability of regulatory regimes will ensure the regulatory parity of domestic and foreign boards of trade. The Exchange also believes that the level of regulatory scrutiny applicable to a foreign board of trade's activities should depend upon the level of contacts in the U.S. and the policy interests implicated by such contacts. In addition, in conducting the comparability review and in establishing other standards, the Commission should focus generally upon electronic access to U.S. markets. NYMEX also supports the Commission's

One North End Avenue  
World Financial Center  
New York, NY 10282-1101  
(212) 299-2000

*The New York Mercantile Exchange is composed of two divisions. The NYMEX Division offers trading in crude oil, heating oil, unleaded gasoline, natural gas, electricity, propane, platinum, and palladium. The COMEX Division offers trading in gold, silver, copper, and the Eurotop 100® index.*

policy of aiding U.S. exchanges in gaining the right to place electronic systems in foreign jurisdictions. Finally, NYMEX urges the Commission to act promptly in promulgating final rules and has serious concerns about any use of interim standards in this area.

## **I. Introduction**

### **A. Proposed Requirements for Exemption from Contract Market Designation**

The Commission is proposing a new Rule 30.11. This rule would establish a petition procedure under which an electronic exchange that operated primarily outside the U.S. could petition the CFTC for an order that would permit use of automated trading systems that provided access to the board of trade from within the U.S. without requiring the board of trade to be designated as a U.S. contract market. If appropriate in light of the information provided in a petition, the Commission would issue an order under section 4(c) of the Commodity Exchange Act ("Act") that would allow a member of the petitioner board of trade or an affiliate thereof to operate automated trading systems that provide access to the board of trade in the U.S., subject to specified conditions.

We understand the conditions to be met before an exemptive order would be issued to include the following:

- the petitioner is an established board of trade whose activities are primarily located in a particular foreign country that has taken responsibility for regulation of the petitioner;
- the petitioner's home country has established a regulatory scheme that is generally comparable to that in the U.S. and that provides basic protections for customers trading on markets and for the integrity of the markets themselves;
- any member (or member affiliate) of the foreign board of trade that solicits or accepts orders for, or accepts money, securities or property in connection with the purchase or sale of foreign futures or foreign options by a foreign futures or foreign options customer via an automated order routing system, or that transmits the order of a foreign futures or foreign options customer via a direct execution system, must be a registered futures commission merchant or a firm exempt from such registration pursuant to an order granted under Rule 30.10;
- except for certain incidental contacts with the U.S., the petitioner is present in the

U.S. only by virtue of being accessible from within the U.S. via its automated trading system;

- the petitioner is willing to submit itself to the jurisdiction of the Commission and the U.S. courts in connection with its activities conducted under an exemptive order;
- the petitioner's automated trading system has been approved by the petitioner's home country regulatory following a review of the system that applied the standards set forth in the 1990 International Organisation of Securities Commissions ("IOSCO") report on screen-based trading systems (as may be revised and updated from time-to-time) or substantially similar standards;<sup>1</sup> and
- satisfactory information sharing arrangements are in effect between the Commission and the petitioner and the petitioner's regulatory authority.<sup>2</sup>

#### **B. Relevant Policy Objectives**

In considering a regulatory approach under which certain foreign automated boards of trade might be permitted to offer electronic access to the U.S. market, the Commission must weigh a number of crucial policy objectives. First, under the Act, the CFTC has general statutory obligations to protect customers and to maintain the integrity of pricing of U.S. markets. In addition, in recent years, the Commission has frequently stated its commitment to a policy of "fair competition" through "even-handed regulation." Also, under Section 15 of the Act, the Commission has a statutory duty to "endeavor to take the least anticompetitive means of achieving the objectives of this Act, as well as the policies and purposes of this Act. . . ." Moreover, in the Federal Register release, the CFTC expressed its support for a policy of "open and free access to global markets." The Commission also confirmed in that release that it is committed to "aiding U.S. exchanges in gaining the right to place electronic systems in foreign

---

<sup>1</sup>Moreover, under the CFTC's proposal, the petitioner would be required to describe any differences between the IOSCO principles and those that were used to perform the technical review. The Exchange believes that such disclosures are also a necessary component of the Commission's review of such petitions for exemptive relief.

<sup>2</sup>The Commission also is proposing a new Rule 1.71, which would apply both to domestic and foreign firms. New Rule 1.71 would clarify that U.S. customers and foreign futures and foreign options customers may place orders for domestic or foreign exchanges via automated order routing systems, provided that such systems meet certain specified requirements.

jurisdictions." In this regard, it is worth noting at the outset that NYMEX strongly supports each of these public policy objectives.

In the Federal Register release, the Commission also stated its belief:

"that the establishment of automated trading systems in the U.S. that provide rapid and proximate access to boards of trade otherwise primarily located outside the U.S. will cause a fundamental change in the nature of global trading and raise substantial issues regarding the regulation of increasingly international or multinational exchanges."

The Commission's task is further complicated by the increasing proliferation of screen-based trading systems, by the rapid rate of change in the development of technology and by the considerable variation among futures exchanges, both foreign and domestic, regarding the system design of their automated systems. Thus, for example, several foreign boards of trade offer electronic order entry systems that are either included in or integrated within their automated systems.

Before turning to its comments on the Proposed Rules, NYMEX wishes to acknowledge the difficult task facing the Commission in its review of this regulatory area. The Exchange also wishes to note the care with which the Commission has undertaken its regulatory review, which commenced with the issuance of a "Concept Release," in which the CFTC sketched the broad outlines of a possible regulatory approach and sought comment on a number of related questions. The Commission received a good number of comments on the Concept Release. The Proposed Rules appear to reflect an evolution of the Commission's views on certain issues from the regulatory approach contained in the Concept Release, which may be based in part upon the Commission's consideration of the comment letters on the Concept Release. In view of this history, the Exchange, in providing informed comment to the Commission on the Proposed Rules, believes that it would be most useful to the CFTC for the Exchange to revisit its comments on the Concept Release and to identify certain areas where the CFTC has modified its proposed regulatory approach, such as a more general approach to the concept of electronic access, and to identify also the areas where further modification is still necessary.

**II. The Commission should modify its Proposed Rules to provide that its review of the comparability of regulatory regimes will ensure the regulatory parity of domestic and foreign boards of trade.**

As noted, proposed new Rule 30.11 would require the petitioner's home country to have a regulatory scheme "generally comparable to that in the U.S. that provides basic protections for customers trading on markets and for the integrity of the markets

themselves.”<sup>3</sup> In this regard, NYMEX has itself placed computer terminals for its own electronic trading system in several overseas countries. Through our contacts with foreign regulators and with foreign boards of trade, we appreciate the fact that other regulatory regimes may have developed differently over time, such as by offering a unified regulatory approach to derivatives products, as compared with the U.S. regulatory model and may also reflect various aspects of the particular business culture of the home country.

We also recognize that such regulatory regimes may in many respects be comparable to our own. Therefore, we generally support a process of Commission review under which a petitioner, which is subject to a regulatory scheme that is indeed comparable to the scheme of U.S. regulatory safeguards, could be eligible to obtain an exemption from the requirement to obtain designation as a contract market for each of its products offered via electronic access.

In this regard, a tacit premise underlying the proposed comparability provision is the apparent recognition by the Commission that not all of the regulatory burdens currently imposed upon domestic boards of trade are truly necessary in order to provide “basic protections for customers trading on markets and for the integrity of the markets themselves.” This conclusion is one that is shared by many participants in the futures industry, including both customers and regulated firms. Therefore, NYMEX also supports the Commission's apparent embracing of this marketplace reality.

However, the Commission proposal, if implemented in its current form, would apply this insight and thus in effect would provide regulatory relief from current regulations only to foreign boards of trade. Domestic boards of trade would continue to be subject to all applicable Commission requirements. Such disparate treatment is clearly inequitable.

---

<sup>3</sup>The Commission indicated in the Federal Register release that a foreign board of trade that has formed a link with a domestic board of trade would not be required to comply with these proposed rules if access to its products via automated trading systems from within the U.S. was limited to the terms of an arrangement with a designated contract market. However, the designated contract market that entered into such a linkage arrangement would need to submit a rule(s) describing the arrangement and the rights and responsibilities of all parties involved in the arrangement to the Commission for approval. The Exchange believes that it is appropriate for the Commission to continue to review such linkages in this manner. In this regard, it has been the Exchange's experience that the review undertaken pursuant to such a process is at least as extensive as that contemplated for foreign boards of trade submitting a petition for exemption.

Under the Act, the Commission has a statutory duty to "endeavor to take the least anticompetitive means of achieving the objectives of this Act, as well as the policies and purposes of this Act. . . ." To assist the Commission in meeting its statutory obligation and to further the Commission's policy of "fair competition" through "even-handed regulation," NYMEX proposes that additional procedures be added to the Commission's rule proposal that would lead to fairer consequences and, ultimately, more competitive markets that thus better serve U.S. customers. Specifically, in considering a petition for exemption from a foreign board of trade, the Commission's review or the related process of public comment on the petition may identify practices permitted under the foreign regulatory regime that are not allowed for domestic exchanges, or may identify significant regulatory restrictions or burdens to which domestic exchanges are subject that are not part of the foreign regulatory regime.

In each such instance, the Commission, in issuing an order pursuant to Section 4(c) of the Act, should craft the order so that the order both grants an exemption to a foreign exchange to provide electronic access to its markets to U.S. persons (whether via a direct execution system or an automated order routing system) and also concurrently grants an exemption collectively to U.S. exchanges that permits such practices or exempts the domestic exchanges from such rules. Moreover, the order should clarify that the failure of the foreign board of trade to comply with any of the conditions of its exemption would not nullify the grant of exemption to the domestic exchanges.

NYMEX is extremely concerned with the regulatory approach contained in the Proposed Rules that would establish disparate treatment of domestic and foreign boards of trade that would seriously disadvantage U.S. exchanges. This approach is inherently inequitable, possibly anti-competitive and could potentially hurt U.S. customers. Therefore, NYMEX suggests that its alternative approach would be a better deal for U.S. markets and customers, and strongly urges the Commission to reconsider and revise its Proposed Rules.

**III. The level of regulatory scrutiny applicable to a foreign board of trade's activities should depend upon the level of contacts in the U.S. and the policy interests implicated by such contacts.**

Another condition contained in proposed Rule 30.11 is that, except for certain incidental contacts with the U.S., the petitioner is present in the U.S. only by virtue of being accessible from within the U.S. via its automated trading system. In this regard, the Commission noted in the Concept Release that "[a]t some level of U.S. activity, a board of trade can no longer claim to be a board of trade located outside the U.S. and would be required to be designated as a contract market."

We strongly agree with this conclusion. In assessing the level of regulation that

should apply to a foreign board of trade's activity in the U.S., the Commission's review should emphasize and distinguish between those products offered by a foreign board of trade which are delivered in the U.S. or are settled by reference to prices derived from U.S. markets and those which are not.

The Exchange believes that an application by a foreign board of trade to provide electronic access to products which have little or no impact on U.S. markets and which are offered to U.S. customers should be reviewed by the Commission to determine whether U.S. customers are adequately protected. When the regulatory interest being invoked is primarily one of customer protection, the CFTC may choose to place greater reliance on the "home" regulator.<sup>4</sup>

On the other hand, with respect to products which are U.S.-delivered or are otherwise U.S.-based, the CFTC generally should require that a foreign board of trade obtain contract market designation for such products so that the standards in effect are consistent with and at least as rigorous as the requirements imposed on domestic boards of trade. As noted in Section 3 of the Act, the prices for U.S. products:

"are generally quoted and disseminated throughout the United States and in foreign countries as a basis for determining the prices to the producer and the consumer of commodities and the products and byproducts thereof and to facilitate the movements thereof in interstate commerce."

In this regard, the recent past demonstrates the adverse effect on U.S. markets and the related need for additional regulation that can result from activity on a foreign board of trade involving a contract for physical delivery that can be delivered in the U.S. Specifically, the CFTC announced on May 14, 1998 that it was issuing an order, in connection with settling the matter by consent, finding that Sumitomo Corporation of Japan ("Sumitomo") manipulated the copper market in 1995 and 1996. The CFTC ordered the company to cease and desist from further violations of those provisions of the Act and to pay a total of \$150 million. In announcing the settlement, the CFTC's

---

<sup>4</sup>In this regard, if all of the contracts offered by a petitioner are not based upon U.S. products or do not involve U.S. delivery, the foreign board of trade's contact with the U.S., absent other information, would appear to be incidental and the Exchange questions whether it is truly necessary to require that foreign board of trade to consent to jurisdiction of the Commission and the U.S. courts in connection with its activities conducted under an exemptive order. In such circumstances, the exchange itself would seemingly have no direct contact with a U.S. customer, who would of course have recourse to bring an action against the intermediary handling the customer's order. The Exchange believes that the CFTC would have sufficient leverage over the foreign board of trade through its ability to condition or revoke the exemption.

Chairperson observed that "[t]oday's settlement imposes a substantial civil monetary penalty in response to misconduct which caused very serious harm to the United States markets and users of copper." In the Commission's order, the CFTC detailed how this manipulation involved London Metal Exchange warehouses located in the U.S. Therefore, it is essential for the Commission to maintain the integrity of pricing of U.S.-based products and require contract market designation for all such products offered by foreign boards of trade.

**IV. In conducting the comparability review and in establishing other standards, the Commission should focus generally upon electronic access to U.S. markets.**

The Proposed Rules depart significantly from the Concept Release in that the Proposed Rules are structured upon two organizing definitions that are intended to be mutually exclusive, "direct execution system" ("DES") and "automated order routing system" ("AORS").<sup>5</sup> In the Federal Register release, the Commission emphasized that the definitions of DES and AORS were structured "so that every device, system or software upon which orders for products traded on boards of trade can be entered from within the U.S. for any electronic exchange would fall into one or the other category."

The Exchange has four comments on these proposed definitions. First, NYMEX's concern with regulatory parity with foreign boards of trade applies regardless of whether an order is transmitted directly to the DES or via an AORS. Therefore, the Commission should clarify in its final rules that the comparability analysis and requirement for regulatory parity is triggered regardless of the means by which an order is transmitted to the foreign exchange.

Second, the Exchange believes that the Commission's proposed definitions, albeit well-intentioned, would create artificial distinctions that may create confusion and uncertainty and that would be inappropriate from a technological perspective.<sup>6</sup> It may

---

<sup>5</sup>In general terms, DES is a term that is intended to encompass any system that allows entry of orders from within the U.S. for an automated board of trade, except those systems that satisfy the definition of AORS. AORSs generally are systems on which customers or their representatives would submit orders through an FCM or rule 30.10 firm for automated execution,

<sup>6</sup>For example, as noted above, certain foreign boards of trade offer electronic order entry systems that are either included in or integrated within their automated systems. If an electronic order entry system is thus made available to a member firm by a foreign board of trade, should such a system be regulated as a DES or an AORS? If regulated as an AORS, the member firm would be responsible under the Proposed

be useful to think of the order flow process to an automated trading system as a continuum. Given the array of options presented by the current state of automated technology, it is possible to envision a broad variety of possible systems and order configurations. For example, a foreign board of trade could determine that its business needs and the needs of its market users are best met through the provision of an exchange order routing system with a "star" configuration, in which orders are first routed electronically to the board of trade, then transmitted to the member firm before being returned to the board of trade for execution. Given that an order, including a customer order, would be routed directly to the foreign board of trade before being transmitted "through" the member firm, how would such a configuration be treated under the CFTC's proposed definitions?

Third, by tying certain system requirements to AORSs, the Commission is in effect dictating particular technology design choices to market participants.<sup>7</sup> This effect is the exact opposite of the Commission's expressed intent.<sup>8</sup> In doing so, the Commission mandates not only would affect initial system design, but also would greatly restrict possible options concerning subsequent modifications of a system in response to changing technology or market conditions. In other words, the Proposed Rules would eliminate a great deal of desired flexibility in such systems.

---

Rules for a series of system requirements that would not appear to be within its control.

<sup>7</sup>In the parlance of software programming, a system may have a number of computer "modules" and each such module constitutes a computer program that performs a specific function. With regard to the submission of an order to an automated electronic trading system, there are many possible choices regarding where a particular module could be placed in that process. For example, a certain module, such as credit-checking or security controls, could be placed in the electronic order entry segment of the technological continuum or it could be placed in the automated trading system segment. However, under the Proposed Rules, the Commission in essence is mandating that some of the most significant modules of this process (namely pre-execution credit and trading or position limit checks, data-blocking capabilities, and security controls) be placed in the AORS. From the standpoint of system design, these modules could be placed just as easily in the DES.

<sup>8</sup>In the Federal Register release, the Commission announced that by using broad definitions, it hoped:

"to create a regulatory approach that provides a flexible means to incorporate the changing nature of technology. The Commission has no desire to dictate particular technology choices to market participants, nor does it wish to restrict innovation, and these rules were crafted accordingly."

Fourth, on an even more fundamental level, the Exchange is opposed to the Commission requiring matters such as credit checking controls as a matter of federal regulation. NYMEX believes strongly that decisions regarding whether to use such controls and, if so, how to establish such controls, should be made according to the best business judgment of the individual firms and the exchanges upon which those firms trade.

**V. NYMEX supports the Commission's policy of aiding U.S. exchanges in gaining the right to place electronic systems in foreign jurisdictions.**

In the Concept Release, the Commission sought comment on whether it should consider if reciprocal access was available to domestic boards of trade before granting access to U.S. markets to a particular foreign board of trade. NYMEX expressed its support for such a policy as a matter of fundamental fairness.

In the Federal Register release for the Proposed Rules, the Commission noted that it had consulted with staff at the U.S. Department of Treasury and the Office of the U.S. Trade Representative regarding U.S. legal obligations under the General Agreement on Trade in Services ("GATS") and the North American Free Trade Agreement ("NAFTA"). Based upon these discussions, the CFTC indicated that it had decided not to propose at this time a requirement that a particular petitioner's home country jurisdiction extend reciprocity to U.S. exchanges' automated trading systems. However, the Commission further noted that it remained committed to a policy of "aiding U.S. exchanges in gaining the right to place electronic systems in foreign jurisdictions." NYMEX encourages the Commission to use every available means to pursue this policy objective.

**VI. NYMEX urges the Commission to act promptly in promulgating final rules and has serious concerns about any use of interim standards in this area.**

The Commission has been giving consideration for some time to the many difficult policy issues in this area. NYMEX believes that the relevant policy issues have been identified, and the time has come for the Commission to act decisively. Therefore, the Exchange urges the Commission, following careful consideration of the comment letters submitted in response to publication of the Proposed Rules, to move promptly and promulgate final rules.

In this connection, in recent weeks, a number of proposals have been floated publicly that would utilize one form or another of interim standards while the Commission completes its consideration of the issues raised by its Proposed Rules. While NYMEX recognizes that these proposals are well-intentioned, we have serious concerns about the advisability of this course of action as a matter of public policy.

For example, some proposals would be based upon a no-action letter issued by CFTC staff more than three years ago. There have been dramatic changes in exchange automation since the issuance of that letter. Indeed, a recent industry survey of exchange automation began by noting that "[l]ightning speed' is hardly adequate to describe the amount of change in automation that the futures industry has experienced" since the last survey, particularly with respect to the preceding six to 12 months.<sup>9</sup>

Electronic access to exchange markets is an area of critical importance to the futures industry. In light of the importance of this area of regulatory policy and in light of the industry developments noted above, NYMEX believes that it would be unwise public policy, for example, to rely solely upon guidelines developed by one division at the Commission over three years ago, particularly in light of the fact that these guidelines never received the benefit of comment and scrutiny by the general public and by the Commission itself.

In this connection, the development of such interim standards was not a subject for which the Commission sought comment in the Federal Register release for the Proposed Rules. Indeed, in that release, the Commission expressed its view that it was not appropriate to grant interim relief either before the Commission's adoption of final rules or pending the Commission's review of a board of trade's petition. Thus, at this time, the public has not been provided with any notice regarding whether such interim relief is under consideration by the Commission, and, if this is the case, any notice regarding what form such relief could take. In order to assure that the public has appropriate notice and opportunity for comment, the Exchange thus believes that is incumbent upon the Commission to publish any such proposal for public comment. However, in view of the fact that the Commission's review of the policy issues in this area has been underway for a good while, the Exchange suggests that, in the event the Commission does undertake active consideration of such interim measures, it should also consider a short comment review period for any such proposal.

In conclusion, NYMEX believes that the Commission should modify its Proposed Rules to provide that its review of the comparability of regulatory regimes will ensure the regulatory parity of domestic and foreign boards of trade. The Exchange also believes that the level of regulatory scrutiny applicable to a foreign board of trade's activities should depend upon the level of contacts in the U.S. and the policy interests implicated by such contacts. In addition, in conducting the comparability review and in establishing other standards, the Commission should focus generally upon electronic access to U.S. markets. NYMEX also supports the Commission's policy of aiding U.S. exchanges in gaining the right to place electronic systems in foreign jurisdictions.

---

<sup>9</sup>Tony Baptiste and Jane Kang-Thorpe, Exchange Automation: The Regulatory Dilemma, Futures Industry, August-September 1998, at 11.

Ms. Jean A. Webb  
April 30, 1999  
Page 12

Finally, NYMEX urges the Commission to act promptly in promulgating final rules and has serious concerns about any use of interim standards in this area.

\* \* \* \*

NYMEX thanks the Commission for the opportunity to submit comments concerning the Proposed Rules and would be pleased to furnish additional information in this regard. If you have any questions, please do not hesitate to contact the undersigned.

Respectfully submitted,



R. Patrick Thompson  
President

cc: Chairperson Brooksley Born  
Commissioner Barbara P. Holum  
Commissioner James E. Newsome  
Commissioner David D. Spears