

October 13, 2003

BY FIRST CLASS MAIL AND E-MAIL submissions@cftc.gov

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

Re: HedgeStreet, Inc.'s Application for Designation as a
Contract Market and Derivatives Clearing Organization

Dear Ms. Webb:

The Board of Trade of the City of Chicago, Inc. ("CBOT®") appreciates the opportunity to comment on the application submitted to the Commodity Futures Trading Commission ("Commission") by HedgeStreet Inc.'s ("HedgeStreet") for designation as a contract market and a derivatives clearing organization.

Introduction

Congress has found that futures and options transactions are "affected with a national public interest by providing a means for managing and assuming price risks, discovering prices or disseminating pricing information through trading in liquid, fair and financially secure trading facilities." 7 U.S.C. §5(a) 2000. Congress intended that the Commodity Exchange Act (the "Act") serve that national public interest "through a system of effective self-regulation of trading facilities, clearing systems and market participants under the oversight of the Commission. 7 U.S.C. §5(b) 2000.

Contract market designation is the centerpiece of that Congressionally-mandated "system of effective self-regulation." 7 U.S.C. §5(b) 2000. Before being permitted to offer trading in futures and options transactions, a board of trade must meet the comprehensive standards for becoming a designated contract market set out by Congress under Sections 5(a)-(d) of the Act and by the Commission in Part 38 of the Commission's Regulations. Similarly an entity seeking to be designated as a Derivative Clearing Organization must comply with the requirements in section 5b(a)-(c) and the Regulations in Part 39.

Although the record in this case is scant, it is apparent that HedgeStreet fails meet the mandatory criteria to become a DCM or a DCO. In fact, HedgeStreet acknowledges as much by contending that its business model allows the Commission to exempt it from

many of those criteria. However, there is nothing in the Act that permits the Commission to dispense with compliance with the Core Principles or the Designation Criterion. Accordingly, HedgeStreet's applications should be disapproved.

HedgeStreet Does Not Qualify as a DCM or a DCO

At the outset, the CBOT notes that the public file on HedgeStreet's application is woefully inadequate. Among other things, HedgeStreet withheld all of the outsourcing agreements between HedgeStreet and the National Futures Association ("NFA").¹ Thus, the non-public exhibits contain the details of the core activities of regulatory services and market supervision procedures. The CBOT has made a request under the Freedom of Information Act for this information and the request is now pending. At the very least, the Commission should defer action on the application until the FOIA issues are resolved. The CBOT and other interested parties will only be able to make meaningful comments when the complete record is made public.

1.) Governance

The application does not identify the management of HedgeStreet. However, based on the fact that HedgeStreet, Inc. is a wholly-owned subsidiary of Pareto Partners Ltd, we assume that Pareto would be charged with operating HedgeStreet or would, at the very least, choose the President of HedgeStreet. This person will then be empowered to choose the members of the Board of Directors and manage the business of the exchange. Given how pivotal the President is to the corporate governance of HedgeStreet, Pareto should be required to designate this person before the Commission approves HedgeStreet's application. Such a delay is especially important here, where Pareto Partners, an entity not subject to the Commission's regulatory authority, will be the de facto guiding hand of HedgeStreet at the outset.

¹ According to the spreadsheet entitled "Satisfaction of Designation Criteria and Compliance with Core Principles Applicable to Contract Markets and Derivatives Clearing Organizations," that HedgeStreet provided with its application (the "Spreadsheet"), HedgeStreet admits that it does not yet have an agreement in place with the NFA for the outsourcing of its regulatory services. In other words, HedgeStreet's entire regulatory regime is not now concrete but rather is based on what HedgeStreet "anticipates" from its yet-to-be-finalized relationship with the NFA. Accordingly, the Commission should suspend its consideration of HedgeStreet's application until such time that HedgeStreet can provide the Commission with actual details instead of what it hopes will occur at some to be determined date. Until that time, HedgeStreet will fail to comply with Designation Criteria 2 in that it is currently lacking the capacity "to prevent market manipulation through market surveillance, compliance and enforcement practices and procedures...."

2.) Clearing

Designation Criterion 5 and Core Principle 11 both require that the transactions executed on a designated contract market must be cleared and settled through a registered derivatives clearing organization. Nothing, however, in the public record spells out how HedgeStreet will operate its clearing arm, except a cursory presentation in its Spreadsheet. Key questions as to the operation of the DCO are unanswered. For example, HedgeStreet states that it will maintain its customers funds in a settlement bank, but it fails to identify the bank, disclose the relationship of the settlement bank to its parent, Pareto Partners, describe how the bank will actually settle the trades, or even provide any assurances that the chosen settlement bank will be able to perform this function.

3.) Membership

Core Principle 14 requires that “[t]he 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.” 7 U.S.C § 7(d)(14) 2000. Under its business model, every users of the HedgeStreet exchange will have direct access to the trading system. Yet, the qualification standards are remarkably low. One need only live in the United States, have a domestic bank account, and deposit \$500 with HedgeStreet’s settlement bank. HedgeStreet contends that no other fitness standards are required because the HedgeStreet Members trade only for themselves. The Act does not recognize that as a ground for dispensing with the requirements of the Core Principles.

4.) Products

The HedgeStreet application is incomplete and unable to demonstrate compliance with Core Principles 3 (Contracts Not Readily Subject to Manipulation) and 7 (Availability of General Information) because it has yet to disclose the specifications of the contracts it intends to offer for trading.

Core Principle 7 requires a board of trade to make information available to the public concerning, among other things, the terms and conditions of its contracts. The application does not include the specifications of the contracts that HedgeStreet intends to offer for trading. HedgeStreet indicates that those specifications will be posted on its website, but this assurance cannot substitute for HedgeStreet’s obligation to demonstrate to the Commission that the public has access to those specifications. Furthermore, in the absence of these specifications, it is also not possible for HedgeStreet to demonstrate its compliance with Core Principle 3 (“The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.”).

5.) Market Surveillance

Designation Criterion 2 requires that a contract market have the capacity to prevent market manipulation through market surveillance, compliance, and enforcement practices and procedures. Core Principle 4 more specifically requires that a contract market monitor trading to prevent price distortion, and disruptions of the delivery or cash-settlement process, in addition to manipulation.

HedgeStreet has represented that NFA will perform surveillance for market manipulation, price distortions and market congestion. However, as we stated, the contract for those outsourced services has not been completed. As a result, there is no way for the Commission to consider, or for other interested parties to comment upon, the dynamics of that relationship. For instance, we have no information on the actual responsibilities the NFA will have or how it will carry out those responsibilities.

Moreover, HedgeStreet's application is largely silent on those regulatory responsibilities it intends to keep in house. For example, HedgeStreet's rules state that it will review data to "alert HedgeStreet when potentially unusual trading activity is takes place." HedgeStreet Rule 7.1. While this is a laudable goal, the rules set forth no detail as to whom will review the records, what records will be reviewed and even more important, what will constitute "unusual activity."

HedgeStreet further proposes to operate without position limits and to omit from its rules a prohibition against market manipulation, thereby violating Core Principle 5. Using specious reasoning, HedgeStreet's application dangerously assumes that the market it operates is not susceptible to manipulation. Manipulation of futures or options products does not turn strictly on whether the underlying product is cash settled or not. Even cash settled futures or option products must be vigorously monitored to ensure that market participants do not use forces outside of the marketplace to affect the price.

Finally, HedgeStreet reserves the right to make adjustments to the outstanding contracts if it deems it necessary to achieve fairness. HedgeStreet Rule 5.1. As with other provisions in its spotty rules, this power is unrestrained. It could be invoked whenever management feels it is appropriate. This is especially troubling when one considers that HedgeStreet management will know the precise position of all market participants when making this "fairness" adjustment.

III. Conclusion

It is clear that HedgeStreet's application is deficient on its face. It expressly refuses to comply with a number of the Core Principles and Designation Criteria in the mistaken belief that those principles and criteria are inapplicable to its business model. However, absent grounds that would warrant the extraordinary exemption provided in Section 4(c) – and such grounds are clearly not present here -- the Commodity Exchange Act does not permit DCM or DCO applicants to decide which of the Core Principles and Designation Criteria apply to them and which do not. Accordingly, the Designated

Contract Market and the Derivatives Clearing Organization Applications of HedgeStreet, Inc. should be disapproved. At the very least, the application should be held in abeyance until HedgeStreet supplements it with sufficient information to fill in what is now lacking. At that point, it should again be offered for comment.

Respectfully submitted,

Bernard J. Dan