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John P. Davidson III  
Managing Director  
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OFFICE OF THE SECRETARIAT

October 23, 2007

Mr. David A. Stawick  
Secretary  
Commodity Futures Trading Commission  
1155 21<sup>st</sup> Street NW  
Washington DC

COMMENT

Received CFTC  
Records Section  
10/24/07

**RE: Petition for Exemptive Relief Pursuant to Section 4(c) of the CEA from Registration as an FCM**

Dear Mr. Stawick:

On July 27, 2007, Chicago Mercantile Exchange Inc. ("CME")<sup>1</sup> petitioned the Commodity Futures Trading Commission ("CFTC") for exemptive relief, pursuant to section 4(c) of the Commodity Exchange Act ("CEA" or "Act") from the requirement that the China Foreign Exchange Trade System and National Interbank Funding Center ("CFETS") and its members register as futures commission merchants ("FCM"). The CFTC placed the petition for exemptive relief in the Federal Register on August 23, 2007, and requested comments be filed within thirty days. On September 21, 2007, the Futures Industry Association ("FIA") requested additional time to submit its comment letter and on October 9, 2007, FIA filed its comment letter. CME submits this letter in response to the FIA comment letter.

FIA opposes the exemption for three reasons. First, FIA argues that the exemption would not promote economic or financial innovation and fair competition. Second, FIA argues that the exemption would not be consistent with the public interest and purpose of the Act. Finally, FIA states that the proposed exemption would adversely affect the ability of the Commission and the CME to discharge their responsibilities. As discussed below, FIA's arguments lack any real substance.

**A. The Exemption Provision within the CEA is Designed to Accommodate Unique Situations not Otherwise Contemplated in the Act**

The FIA argues that CFETS' inability to satisfy all of the CEA's registration requirements for an FCM is a reason that it should not receive an exemption from FCM registration. This argument is faulty.

Section 4(c) of the CEA provides in part that the Commission may grant an exemption under the following circumstances.

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<sup>1</sup> CME Group (<http://www.cmegroup.com/>) is the world's largest and most diverse exchange. Formed by the 2007 merger of the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT), CME Group serves the risk management needs of customers around the globe. As an international marketplace, CME Group brings buyers and sellers together on the CME Globex electronic trading platform and on its trading floors. CME Group offers the widest range of benchmark products available across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, agricultural commodities, and alternative investment products such as weather and real estate.

- i. The exemption will promote economic or financial innovation and fair competition.
- ii. The exemption will be consistent with the public interest and the purposes of the CEA.
- iii. The exemption will not have a material adverse effect on the ability of the Commission or any contract market to discharge its self-regulatory duties under the CEA.

CFETS is a sub-institution of the Peoples Bank of China ("PBC"). CFETS is not separately capitalized and as a sub-institution of a central bank of a sovereign nation is not able to directly subject itself to the jurisdiction of the CFTC. Nonetheless, this unique and internationally important arrangement with CFETS fully satisfies the FCM registration exemption requirements of section 4(c) of the CEA.

#### **B. The Exemption Request Promotes Economic or Financial Innovation and Fair Competition**

Pursuant to the Agreement for Order Routing and Super-Clearing ("Agreement") between CME and CFETS, CME agreed to provide extensive education and training to CFETS with respect to the operations of the futures industry. The purpose of the training is to familiarize both CME and CFETS with the trading conventions and regulatory environment each is operating under in their home jurisdictions. Although CME is expending a large amount of financial and human capital as part of the Agreement with CFETS, U.S. businesses, including FCMs, bookkeeping services, technology companies and others will certainly reap long-term benefits from the exposure CFETS, CFETS member banks, Chinese regulatory authorities, the PBC and the country of China are receiving as a result of the education and training provided by CME. Contrary to the assertion by FIA, any net financial benefit that may ultimately be received by CME as a result of the arrangement with CFETS will not be realized, if at all, until sometime in the distant future.

The FIA argues that there are no financial or economic innovations that are expected to flow from the super-clearing relationship. This conclusion is incorrect. The training and education provided by CME to CFETS has been broad-based and comprehensive. CFETS staff has received training on the operations and risk management procedures of an exchange and a clearing house. CFETS staff has also met with representatives of the CFTC and the National Futures Association to gain a better understanding of the regulatory roles these entities play in the derivatives industry. CFETS business and technology staff has received training in Shanghai by CME focusing on margin procedures, segregation requirements and high level trading, order-routing, clearing and risk management functions. CME has also met with Chinese banking and regulatory officials to discuss exchange management, market surveillance and regulation. The mutual training and education received in connection with the super-clearing arrangement will undoubtedly lead to further financial and economic innovation in China.

To emphasize the importance of this relationship to the U.S. government's on-going efforts to foster a relationship with China, on June 8, 2004, as a precursor to the Agreement, CME and CFETS executed a Memorandum of Understanding ("MOU"). At that time, Treasury Secretary Snow stated that "this cooperative initiative is an outstanding example of the kinds of exchange-rate-related technical cooperation efforts Treasury has consistently advocated

as part of our on-going technical cooperation program with China's financial sector and financial regulators."

The MOU and the subsequent execution of the Agreement represent a commitment by China to strengthen its financial system and to become more integrated into the world capital markets. In addition, the technological cooperation between CME, CFETS and other third parties, necessitated by the arrangement, will provide benefits to other entities that transact business in China. CME believes that the technology and education provided through the super-clearing arrangement will assist other entities to further innovate in China.

China has demonstrated a willingness to become more open to the world's capital markets. In fact, a recent press release indicated that J.P. Morgan Chase & Co. won governmental approval in China to form a joint venture with a Chinese futures-brokerage firm. The press coverage states that, "the U.S.-based bank's venture comes as international investment banks are scouring China for joint-venture partners to take advantage of growing global interest in the country's exchanges. The partnership with Zhongshan Futures Co. a futures brokerage based in southern Guangdong province, gives J.P. Morgan the ability to trade on China's commodities exchanges, which feed China's huge and growing appetite for commodities and influence prices on global markets."<sup>2</sup>

The Agreement between CME and CFETS is limited to certain foreign currency and interest rate products. The entities that will participate in the super-clearing arrangement are entities that would otherwise not be able to trade regulated foreign currency and interest rate products in the United States. Through the super-clearing arrangement, member banks of CFETS will be exposed to, and gain experience in, trading U.S. derivative products. This experience in trading and financial market operations will ultimately benefit the entire U.S. futures industry and all of its participants as the regulatory environment in China continues to evolve and become more open to U.S. businesses.

**C. The Exemption Request is Consistent with the Public Interest and the Purposes of the CEA**

CFETS is not separately capitalized and does not have a separate balance sheet.<sup>3</sup> Accordingly, CFETS is not technically able to satisfy CME rules related to capital. However, contrary to FIA's assertion that CFETS will not be subject to financial, recordkeeping and reporting, and customer protection requirements, CFETS will be subject to all of the non-capital CME rules applicable to a clearing member. In addition, CFETS will also be subject to the risk management and financial oversight provided by the CME Clearing House and the CME Market Regulation Department. CFETS will, for example:

- i. Satisfy CME's security deposit requirement (\$500,000 minimum which may be risk adjusted upward as necessary).
- ii. Satisfy the financial equivalent of CME's membership and share requirement for clearing members.
- iii. Comply with all applicable settlement and performance bond payments through a CME-approved bank domiciled in the U.S.

<sup>2</sup> Toehold in China Futures, Dow Jones Newswire, Rick Carew (September 26, 2007).

<sup>3</sup> The Peoples Bank of China currently has foreign currency reserves of approximately \$1.3 trillion.

- iv. Be subject to daily mark-to-market and margining of its CME positions.
- v. Be subject to CME's real-time position and price information at the super-clearing and individual CFETS member level.
- vi. Be subject to CME's Large Trader reporting and Account Monitoring systems.
- vii. Be subject to on-going surveillance and audit activities of CME Clearing and on-going review by the CME Clearing House Risk Committee, the primary governing body for CME Clearing risk management policies and programs.

Accordingly, CFETS will be subject to virtually all of the risk management and financial oversight requirements that any other "registered" FCM is subject to with the exception of certain capital requirements it is not able to meet given the structure of the PBC. CFETS' inability to register as an FCM does not compromise the public interest. On the contrary, the protections set forth in the Agreement and the requirements in the proposed CFTC Order satisfy the customer protection, market integrity and financial integrity interests of the marketplace.

The CFTC has the ability to request documents or information from CME or CFETS regarding the super-clearing arrangement. The CFTC also has the final authority to terminate the super-clearing arrangement if it determines any part of the arrangement poses a risk. In the event the CFTC encounters any non-compliance with the terms of its Order by CME or CFETS, the CFTC may revoke the Order and/or hold CME responsible for any noncompliance with the Order. A revocation of the Order will also result in the termination of the super-clearing arrangement.

The super-clearing arrangement does not prohibit CFETS members from trading foreign currency and interest rate products through any entity once the Chinese government relaxes its existing regulations regarding foreign investments. There is no exclusive requirement in the Agreement that CFETS members trade U.S. derivative or any other products only through the super-clearing arrangement. Additionally, the super-clearing arrangement only applies to a limited number of foreign currency and interest rate products.

Importantly, nothing in the Agreement may be interpreted to modify or override CME's authority as a designated contract market ("DCM") and derivatives clearing organization ("DCO") to take action, modify practices or modify requirements under its emergency powers. In the event CME determines that an emergency situation is present, it can take any necessary actions to resolve the situation. In addition, the Agreement and the legal relationships of CME and CFETS are governed by and construed in accordance with the laws of the United States.<sup>4</sup>

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<sup>4</sup> CFETS has agreed to be subject to U.S. law and the applicable Rules of CME. Accordingly, CFETS will be subject to assessment pursuant to Rule 802 in the event of a default by another CME clearing member. In addition, in the unlikely event of a CFETS default (PBC has foreign currency reserves in excess of \$1.3 trillion), not only are all of CFETS' customers non-U.S. citizens but CME will be segregating CFETS customer funds at the CFETS level. Further, generally speaking, assets of a bankrupt foreign FCM held in the U.S. would be subject to the jurisdiction of a U.S. bankruptcy court. A court or other governmental agency presiding over a bankruptcy proceeding in the home country of the FCM would have no jurisdiction over its U.S. assets but can ask a U.S. bankruptcy court to "recognize" the foreign bankruptcy proceeding, which results in the application of U.S. bankruptcy law to the foreign FCM's U.S. assets. Accordingly, in such a bankruptcy situation, there would be no barrier to CME's termination and liquidation of its contracts with the foreign FCM, netting obligations across products and applying the foreign FCM's security deposit and any other available assets to satisfy any net obligation to CME. Our analysis indicates that the above procedures would also apply to CFETS.

**D. The Exemption Request Will Not Have a Material Adverse Affect on the Ability of the Commission or Any Contract Market to Discharge its Self-Regulatory Duties Under the CEA**

CME is a self-regulatory organization registered as a DCM and a DCO with the CFTC and is statutorily required to remain in compliance with all of the applicable CFTC Core Principles. The super-clearing arrangement with CFETS in no way impacts CME's ability to comply with its statutory responsibilities on a daily basis.

The CFTC will not be impacted in any manner by the super-clearing arrangement from conducting regular rule enforcement reviews of CME as it currently does in its normal course of business or from requesting information about trading activity through the super-clearing arrangement. If the CFTC finds any aspect of CME's risk management or financial oversight of the relationship to be lacking, the CFTC has the authority to revoke its Order and terminate the super-clearing arrangement.

Additionally, if CME determines that CFETS is in breach of the Agreement at any time, CME can terminate the Agreement. In addition, CME has the unilateral right to terminate the participation of individual CFETS member banks in the super-clearing arrangement if CME believes the member bank poses a financial, operational or compliance risk to the Exchange or any of its clearing members. Accordingly, there are a number of safety features built into the super-clearing arrangement and the CFTC's proposed Order that allow CME to scale back participation by CFETS member banks or that allow CME and the CFTC to terminate the arrangement.

**E. Conclusion**

The FCM exemption request of CFETS and its member banks should be granted. FIA's comment letter does not raise any bona fide reason why the exemption should not be approved. As set forth above, the exemption request promotes economic and financial innovation and fair competition. The request is consistent with the public interest and the purposes of the CEA. Finally, the exemption request will not have a material adverse affect on the ability of the CFTC or CME to discharge their statutory and self-regulatory duties.

In addition, FIA's request to further delay approval of the FCM exemption request, as set forth in the last paragraph of its comment letter, should be rejected. The CFTC placed the exemption request in the Federal Register for a thirty day comment period. On the twenty-ninth day of the comment period, FIA asked for "additional time to submit a comment letter."<sup>5</sup> The CFTC provided FIA fourteen days to file its comment letter. On the fourteenth day of the extension period, FIA filed its comment letter. The last paragraph of FIA's comment letter states in part that, "If, notwithstanding the foregoing, the Commission determines that the petition should be granted, subject to certain terms and conditions, we request that any such terms and conditions, as well as the contractual terms agreed by the parties, be published for additional comment before the Commission takes any action to approve the CME petition."<sup>6</sup>

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<sup>5</sup> FIA letter from its General Counsel to the CFTC requesting additional time to file a comment letter. (September 21, 2007)

<sup>6</sup> Id.

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Prior to filing its comment letter, representatives of FIA requested a meeting with CME. CME displayed its good faith by arranging a meeting with these representatives. CME staff then explained the risk management and financial safeguards associated with the super-clearing arrangement and answered FIA's questions. FIA's new request is unwarranted and the Commission should not allow this request to further delay the implementation of this unique and innovative super-clearing relationship between CME and CFETS. As CME has demonstrated previously and once again in this letter, granting the requested exemption pursuant to section 4(c) of the CEA is entirely appropriate. We urge the Commission to do so promptly.

Very Truly Yours,



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

Division of Clearing and Intermediary Oversight  
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