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**CME Group**  
A CME/Chicago Board of Trade Company

2007 DEC 26 PM 5:15

John P. Davidson III  
Managing Director  
Chief Corporate Development Officer

RECORDS SECTION

December 18, 2007

Commissioner Michael V. Dunn  
Commodities Future Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, NW  
Washington DC 20581

COMMENT

Commissioner Bart Chilton  
US Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, NW  
Washington DC 20581

OFFICE OF THE SECRETARIAT

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Dear Commissioners Dunn and Chilton:

On December 12, 2007, you met with Leo Melamed and Bo Chambliss to discuss Chicago Mercantile Exchange Inc.'s ("CME") order routing and super-clearing arrangement with the China Foreign Exchange Trade System and National Interbank Funding Center ("CFETS"). At the close of the meeting, you sought clarification of a number of issues, which is provided below.

**(i) Promotion of economic or financial innovation and fair competition**

The Agreement for Order Routing and Super-Clearing ("Agreement") between CME and CFETS states that CME will provide extensive education and training to CFETS with respect to the operations and regulation of the futures industry. The purpose of the training is to familiarize CFETS with the trading conventions and regulatory environment in the United States. CME is expending substantial financial and human capital to meet its commitment to CFETS. We expect that U.S. businesses, including FCMs, bookkeeping services, technology companies and others will reap long-term benefits from the exposure to CFETS, CFETS member banks, Chinese regulatory authorities, the Peoples Bank of China ("PBC") and the country of China as a result of the education and training provided by CME.

The training and education provided by CME to CFETS to date 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 training and education received by CFETS in connection with the super-clearing arrangement will lead to further financial and economic innovation in China. CFETS will receive additional education and training in the future as the relationship between the parties matures.

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 party vendors, necessitated by the arrangement, will provide benefits to other entities that transact business in China now and in the future. 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>1</sup>

The Agreement between CME and CFETS is limited to a narrow group of financial products which include certain foreign currency and interest rate products. The Chinese entities that will participate in the super-clearing arrangement are entities that would not otherwise 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 continue to evolve and become more open to U.S. businesses. As Chinese entities gain experience and expertise in trading the narrow group of derivative products that are included within the Agreement, they will likely seek assistance from other U.S. businesses in the future in order to trade different derivative products under more complex trading strategies. The Agreement and the relationship between CME and CFETS is an important step in that maturation process.

**(ii) FCM Registration**

CFETS is not separately capitalized and does not have a separate balance sheet because it is a sub-institution of PBC. In addition, CME has been informed by CFETS that its "parent," the PBC, will not allow CFETS to register as an FCM in the United States or to create a separate FCM entity. However, as discussed in previous filings with the CFTC, CFETS will be subject to all of the non-capital CME rules applicable to every other CME clearing member. CFETS will, for example:

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<sup>1</sup> Toehold in China Futures, Dow Jones Newswire, Rick Carew (September 26, 2007).

- 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 and maintain such collateral in a CME account in the U.S.
- iii. Comply with all applicable settlement and performance bond payments through a CME-approved bank domiciled in the U.S.
- 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.

**(iii) Performance guarantee**

CME has been provided with a legal opinion from King & Wood, a Chinese law firm, that states in part that:

- i. CFETS has the power and authority to execute, deliver and perform all of its obligations under the Agreement,
- ii. The signing of the Agreement by CFETS does not violate any laws, rules or regulations of the PBC,
- iii. The obligations and responsibilities of CFETS that are set forth in the Agreement are legally binding and enforceable against CFETS pursuant to the laws, rules and regulations of the PBC, and
- iv. The performance by CFETS of its obligations under the agreement does not violate any laws, rules or regulations of the PBC.

The Agreement between CME and CFETS is governed by U.S. law, and, in addition, CFETS will be subject to all applicable CME Rules. If CFETS defaults on its obligations under the Agreement, U.S. law and CME Rules will be applicable to such default and, as the King & Wood legal opinion provides, "the obligations and responsibilities of CFETS that are set forth in the Agreement are legally binding and enforceable against CFETS."

Notwithstanding the above, the Federal Register release dated August 23, 2007, which discusses the CFETS petition contains a number of conditions to be imposed on the arrangement including a condition that CME and CFETS will be jointly and severally liable for any Commission enforcement action relating to compliance with any order issued by the Commission. Accordingly, CME is highly motivated from a financial perspective to have robust risk management, large trader and other protections in place to greatly reduce any potential joint and several liability to the CFTC. Further, it is unlikely that PBC would be willing to suffer the reputational risk associated with letting CFETS fail given that PBC has foreign currency reserves in excess of \$1.3 trillion and any trading associated with the Agreement is anticipated to be very modest.

If you have any further questions regarding the Agreement or any other aspects of the arrangement between CME and CFETS, please let me know.

Very truly yours,



cc: Honorable Walter Lukken, Acting Chairman  
Honorable Jill E. Sommers, Commissioner

Ananda Radakrishnan, Director, Division of Clearing  
and Intermediary Oversight

Jacqueline Hamra Mesa, Director, Division of International Affairs

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