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August 15, 2000

Ms. Jean A. Webb
Office of the Secretariat
COMMODITY FUTURES TRADING COMMISSION
1155 21st Street, N.W.
Washington, D.C. 20581

COMMENT

RE: Regulatory Reinvention

Dear Ms. Webb:

The Chicago Mercantile Exchange ("CME") is pleased to offer these comments on a series of rulemaking proposals recently published by the Commission on regulation of multilateral transaction execution facilities ("MTEFs"), regulation of clearing organizations, regulation of intermediaries and expansion of the swaps exemption. The CME strongly supports the stated purpose of these proposals – to "move the Commission from a direct to an oversight regulator, replacing prescriptive rules with broad performance standards in the form of core principles." The CME agrees with the Commission that the proposed regulatory structure "will promote innovation, maintain U.S. competitiveness, and at the same time reduce systemic risk and protect customers."

While the CME strongly supports the objectives and overall thrust of the rulemaking proposals, we believe that certain aspects of the proposals do not represent the best means of accomplishing those objectives. Our comments below will focus on certain areas where we think the proposals could be improved.

I. REGULATORY FRAMEWORK FOR MTEFs

The Commission proposes to use its exemptive authority under Section 4(c) of the Commodity Exchange Act ("Act") to establish three regulatory tiers for markets: recognized futures exchanges ("RFEs"), derivatives transaction facilities ("DTFs") and exempt MTEFs. The manner and degree of regulation of each tier would differ in accordance with the types of products traded on the different categories of markets and the sophistication of the participants using such markets. The CME supports this use of the Commission's exemptive authority and agrees that the proposed exemptions would be consistent with the public interest and would have no adverse effect on any of the regulatory or self-regulatory responsibilities imposed by the Act.

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The three categories of markets can be distinguished as follows. Any product (except stock index contracts) can be traded on an RFE, and any person is eligible to trade on such markets. RFEs would be subject to fifteen core principles. Existing U.S. futures exchanges would automatically qualify to become RFEs. Markets operated as DTFs would be subject to an intermediate level of regulation consisting of seven core principles. DTFs can trade specified types of commodities that have a low susceptibility to manipulation. In addition, a facility that restricts participation to "eligible commercial participants" would be eligible to become a DTF to trade contracts based on any commodities except for stock index contracts or enumerated agricultural commodities. Exempt MTEFs can trade futures on specified types of commodities that are highly unlikely to be susceptible to manipulation. Only institutional traders would be allowed to participate in such transactions. Exempt MTEFs would be exempt from all of the requirements of the Act, except for anti-fraud and anti-manipulation provisions. Exempt MTEFs can not hold themselves out as being regulated by the Commission.

Treatment of Stock Index Contracts

Stock index contracts would not be eligible to be traded on an RFE, DTF or exempt MTEF under the Commission's proposals. This means that the proposed regulatory reforms would not apply to this important category of products. Rather than being subject to flexible core principles, the trading of stock index contracts would continue to be subject to every prescriptive regulation in the CFTC's rulebook applicable to designated contract markets.

For an exchange such as CME that trades a wide variety of products, including stock index contracts, the beneficial effects of the proposed regulatory reforms will be greatly diminished because certain products will continue to be regulated under the existing set of rules, while other products will be regulated under new core principles. This will add an additional layer of complexity to market regulation that will make it more difficult for both markets and market participants to keep track of what regulatory requirements apply to which products. Instead of having only the three tiers of market regulation described in the Commission's proposal, every market that trades stock index futures will also be subject to a fourth tier that includes every regulation in the CFTC's rulebook applicable to designated contract markets.

There is no suggestion in the Commission's release that this separate treatment of stock index contracts is necessary for regulatory or policy reasons. Instead, the Commission appears to believe that it lacks the legal authority to reform the regulation of stock index futures markets because of certain wording in Section 4(c) of the Act. That section authorizes the Commission to "exempt any agreement, contract, or transaction . . . from any other provision of this Act (except Section 2(a)(1)(B))," if the Commission makes certain determinations. Section 2(a)(1)(B) (often referred to as the "Shad-Johnson Accord") sets forth certain substantive and procedural requirements for designating a board of trade as a contract market with respect to stock index futures contracts. The purpose of inserting the limiting language in Section 4(c) was to ensure that the Commission could not use its exemptive authority to eliminate the

requirements specified in the Shad-Johnson Accord. However, the fact that the Commission is prohibited from exempting a contract market from the specific requirements set forth in the Accord does not mean that the Commission is barred from using its Section 4(c) authority to exempt a market that is trading stock index futures contracts (after satisfying the Accord requirements) from other provisions of the Act. Indeed, Section 4(c) expressly authorizes the Commission to grant exemptions from "any" provision of the Act except for Section 2(a)(1)(B).

There may be some confusion concerning this issue because Section 2(a)(1)(B) contains a requirement that an exchange wishing to trade stock index futures contracts must apply for designation as a contract market. Under the Commission's rulemaking proposals, designated contract markets are treated as a separate category from RFEs or DTFs. However, in our view, that distinction is more semantic than substantive. Under proposed Regulations 37.1 and 38.1, DTFs and RFEs are deemed to be subject to all of the provisions of the Act and Commission regulations thereunder which are applicable to designated contract markets. Proposed Regulations 37.2 and 38.2 then provide exemptive relief from certain provisions of the Act and Commission regulations for DTFs and RFEs, provided that certain terms and conditions are met. The reasoning behind the Commission's proposal contains the following steps:

1. It starts with the premise that markets operating as DTFs or RFEs are not designated contract markets.

2. It provides that DTFs and RFEs are subject to all of the provisions of the Act applicable to designated contract markets.

3. It exempts DTFs and RFEs from certain provisions of the Act, provided that certain conditions are met.

The CME believes that the approach described above is unnecessarily convoluted. The same result can be reached in a more straightforward manner by starting with a different premise:

1. Start with the premise that the term designated contract market means any MTEF where the trading of futures is subject to Commission regulation. Under this approach, DTFs and RFEs are simply categories of designated contract markets.[1]

2. Grant exemptions to DTFs and RFEs from certain provisions of the Act, provided that certain conditions are met.

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1 The Commission has made it clear that customers should be informed of the regulatory status of the markets on which they trade. Proposed Regulation 5.1 requires that a contract listed for trading pursuant to exchange certification by an RFE be so identified in its rules. Proposed Parts 36, 37 and 38 require that products listed for trading on an electronic system by an exempt MTEF, a DTF or an RFE be identified as such. These disclosure requirements would still apply under the CME's suggested approach.

This approach has two advantages over the one taken in the proposed rulemaking. First, it is less complex and easier to understand. Instead of four levels of market regulation, there would be only three – RFEs, DTFs and exempt MTEFs. There would be no need for a separate category for designated contract markets that are neither RFEs nor DTFs. Second, this approach would remove any grounds for objecting to having stock index futures contracts traded at an RFE. Because an RFE is a form of designated contract market, allowing stock index futures contracts to be traded under the regulatory regime of an RFE would not violate any of the requirements of the Shad-Johnson Accord. Of course, the initial application for designation would still have to satisfy the Accord's special procedural and substantive requirements. But once the contract is designated, there is no reason why it should not thereafter be regulated in accordance with the core principles applicable to an RFE.

The CME's suggested approach also helps to clarify the extent to which transactions executed on an RFE or DTF may be subject to other federal or state statutes. Section 12(e)(2) of the Act generally provides that the Act does not supersede or preempt the application of federal or state statutes to any commodity transaction that is not conducted on or subject to the rules of a contract market.[2] Thus, a Commission finding that RFEs and DTFs are designated contract markets would have the desirable effect of preempting the application of other federal and state statutes to transactions executed on such markets.

Treatment of RFEs

Existing U.S. futures exchanges would automatically qualify to become RFEs with respect to all of their futures contracts, with the notable exception of stock index futures. For the reasons discussed in the preceding section, the CME strongly believes that stock index futures contracts should be eligible to be traded on an RFE.

Part 38 of the proposed regulations contains an exemption for transactions effected on an RFE, provided that certain conditions are met. If the transactions are to be cleared, the clearinghouse must be authorized by the Commission under Part 39. When the products of an RFE are traded on an electronic system, they must be clearly identified as being subject to the provisions of Part 38. When the products are traded in a physical trading environment, they must be traded in a location separate from products traded on a facility that is regulated as a DTF or exempt MTEF. The CME understands that this requirement can be satisfied by having RFE products traded in a separate pit from DTF products or exempt MTEF products, even though such separate pits may all be located on a single trading floor. We ask the Commission to confirm that our understanding is correct.

Proposed Regulation 38.5(b) provides that a contract traded on an RFE is not voidable in the event that (1) the RFE violates a provision of Part 38 or (2) the Commission disapproves a

2 See Philip McBride Johnson's recent article, "Assessing the CFTC's 'New Regulatory Framework,'" 6 *Derivatives Quarterly* 23 (Summer 2000) for a fuller discussion of the issues raised under Section 12(e) by the Commission's proposal.

rule of the RFE. The CME supports this provision and similar provisions in Parts 36 and 37 because they help to ensure legal certainty for market participants.

The centerpiece of the proposed regulatory restructuring is the replacement of the CFTC's detailed, prescriptive regulations with more flexible core principles. An entity that is regulated as an RFE would be subject to 15 core principles, ranging from a requirement to monitor and enforce its rules to an admonition to avoid unreasonable burdens on competition not necessary or appropriate in furtherance of the objectives of the Act or the regulations thereunder. The CME strongly supports the Commission's approach in moving from prescriptive regulations to core principles. However, we note that many of the core principles are general in nature and susceptible to different interpretations. It is likely that there will be occasions when an RFE will take a particular action that it believes to be consistent with the core principles, but that the Commission or its staff might disagree. We believe that it would be desirable to provide a mechanism for resolving such disagreements short of the Commission taking punitive action against the RFE.

From the viewpoint of a regulated exchange, one of the most important reforms being proposed is the elimination of the requirement that the Commission must approve an RFE's rules and rule amendments prior to implementation. The CME has long advocated that reform, and we commend the Commission for embracing it. Unfortunately, this reform is not proposed to be extended to terms or conditions of a contract for future delivery of an agricultural commodity listed in Section 1(a)(3) of the Act. We understand that certain agricultural organizations have asked the Commission to preserve its pre-approval function for changes to terms or conditions of agricultural contracts, but we believe that the agricultural markets would be better served if RFEs had the same ability to change terms and conditions of agricultural contracts as they do for financial contracts.

The Commission would retain the authority to stay the effectiveness of a rule implemented by an RFE during the pendency of a proceeding to disapprove, alter or amend the rule. The CME believes that rules adopted by an exchange should be presumed to be lawful and valid. We therefore believe that the Commission should not have the authority to stay the operation of an exchange rule simply because disapproval proceedings have been initiated. In an emergency situation, the Commission has authority under Section 8a(9) of the Act to direct an exchange "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 . . . ." The Commission can take such action without providing advance notice or a hearing.

It is stated in the application guidance to Core Principle No. 11 that an RFE is not required to have, monitor or enforce rules requiring intermediaries to provide risk disclosure or to comply with other sales practices. The accompanying release explains that provision as follows:

> Furthermore, the exchanges would no longer be responsible for auditing intermediaries' sales practices. Instead, enforcement would be the responsibility of a registered futures association [NFA].

The CME does not object to this guidance if its purpose is simply to confirm that an exchange may voluntarily choose to delegate the responsibility for sales practice audits to the NFA. However, the CME strongly opposes any suggestion that an exchange must delegate such responsibility to NFA.

Treatment of DTFs

Markets operated as DTFs would be subject to an intermediate level of regulation consisting of seven core principles. DTFs can trade specified types of commodities that have a low susceptibility to manipulation. In addition, a facility that restricts participation to "eligible commercial participants" could become a DTF to trade contracts based on a broader range of commodities. As noted in the Commission's release, a market that is eligible to be an exempt MTEF (discussed below) may voluntarily become a DTF in order to become a "recognized" market.

At first glance, it appeared that the DTF category might provide a useful "middle ground" between the more heavily regulated RFEs and the unregulated exempt MTEFs. However. the Commission's proposed Part 37 contains so many conditions and restrictions for DTFs that it is doubtful that this category will prove to be of much practical value.

As noted above, a facility that restricts participation to "eligible commercial participants" that trade for their own account would be eligible to become a DTF to trade contracts based on any commodities other than stock index futures or the enumerated domestic agricultural products. The Commission requested comment on the advisability of allowing such agricultural products to be traded on a DTF. The CME believes that, so long as participation in the market is limited to eligible participants, they should be allowed to trade any commodity through a DTF, including stock index futures and domestic agricultural products.

The definition of "eligible commercial participant" is limited to an entity listed in certain sections of Part 35 (the swaps exemption) that, in connection with its business, makes and takes delivery of the underlying physical commodity or is a dealer that regularly provides hedging. risk management or market-making services to such entities. This definition is much more limited than the definition of "eligible participant" in Regulation 35.1(b). The following types of entities are eligible to participate in unregulated swap transactions, but do not qualify as "eligible commercial participants" for purposes of the DTF exemption: investment companies, commodity pools, ERISA plans, broker-dealers, FCMs, floor brokers, floor traders, or natural persons with total assets exceeding $10 million.

The Commission's release indicates that existing exchanges would be able to operate DTF markets and that they could choose either open outcry or electronic trading for such markets. However, as a practical matter, the restrictions in Part 37 make it impossible for an exchange to operate a DTF market. Professional floor traders are needed to provide liquidity. When a market order to buy a contract comes into the market, and there is no sell order in the market at that time, the floor traders act as market-makers and take the other side of the incoming order. Institutional investors such as investment companies, commodity pools and ERISA plans also provide liquidity to the market. Since participants that are commercial users of a product often want to buy (or sell) at the same time in response to conditions in the underlying commodity market, it is important for a market to have other types of participants whose buying and selling decisions are based on different factors.

The only explanation given in the Commission's release for limiting participation in a DTF commercials-only market is the following sentence: "This type of eligible commercials-only market structure lessens many of the regulatory concerns regarding manipulation ordinarily present with contracts for tangible commodities." It is unclear what "regulatory concerns" would be raised by allowing floor traders and institutional investors to participate in such a market. Is the Commission concerned that floor traders and institutional investors are more likely to manipulate the market than commercial participants? We know of no factual basis to support that proposition. To the contrary, in the largest manipulation case in recent memory involving the copper market, the party causing the manipulation would certainly qualify as an eligible commercial participant. Is the Commission concerned that floor traders and institutional investors are more likely to be the victims of manipulative conduct by other parties? Yet these entities are considered to be sophisticated enough to participate in totally unregulated swap transactions under Part 35. It is inconsistent to allow them to participate in unregulated transactions because of their sophistication, but to prohibit them from participating in DTF transactions that are subject to Commission oversight and seven core principles of market regulation.

The other way in which a facility can qualify for the DTF exemption is to limit its market to contracts that have been determined by the Commission to be highly unlikely to be manipulated. In order to participate in such a DTF market, participants must either be "eligible participants" as defined in Part 35, or obtain access through a registered FCM that is a member of a recognized clearing organization and has an adjusted net capital of at least $20 million. The CME believes that these conditions are overly restrictive.

Part 35 provides an exemption for certain bilateral transactions. A facility that offers multilateral transactions is not eligible for the Part 35 exemption. Accordingly, in deciding which categories of participants would be eligible for bilateral transactions under Part 35, the Commission did not need to consider what types of participants would be needed for an MTEF. As discussed above, professional floor traders are necessary to provide liquidity in an MTEF market. However, under current Regulation 35.1(b)(2)(x), a floor trader who is a natural person can qualify as an "eligible participant" only if he or she has total assets exceeding $10 million – a

requirement that is out of reach for most floor traders. Floor traders are able to participate in exchange markets without being multimillionaires because their transactions are guaranteed by a clearing member firm. The same approach would work for floor traders who wish to participate in markets that are operated as DTFs or exempt MTEFs. The CME urges the Commission to amend the definition of "eligible participant" for purposes of Parts 36 and 37 to enable floor traders to qualify for that status if their transactions are guaranteed by a clearing member firm.

The CME believes that it is neither necessary nor appropriate for the Commission to set a higher capital requirement at an arbitrary $20 million level for FCMs wishing to handle non-institutional customer business on a DTF. This special capital requirement appears to be based on the premise that transactions on a DTF entail a higher degree of financial risk than do transactions on an RFE. We disagree with that premise, especially in the context of futures based on liquid financial instruments where there is very little risk of manipulation. If the capital requirement for an FCM under the general net capital rule is set appropriately given the risk of the activities undertaken by the FCM, then we see no reason for a special, higher requirement for an FCM that executes transactions on a DTF. (The CME's views on the net capital rule generally are discussed below in the section on regulation of intermediaries.)

Other than the restrictions on products and eligible participants as discussed above, the conditions for obtaining the DTF exemption under Part 37 are similar to those for RFEs under Part 38. Existing designated futures exchanges would automatically qualify to become DTFs.

Treatment of Exempt MTEFs

As its name suggests, an exempt MTEF would be exempt from CFTC regulation. An exempt MTEF is prohibited from claiming that it is regulated, recognized or approved by the Commission. The exemption would apply to MTEFs that are open for trading only to eligible participants and only for contracts based on enumerated financial instruments or indices that are not susceptible to manipulation.

The Commission's release requested comment as to whether futures on government securities (such as U.S. Treasury bills, notes, and bonds) should be eligible to be traded on an exempt MTEF. The CME believes that such contracts should be eligible. We believe that the government securities market is highly liquid and highly unlikely to be susceptible to manipulation.

The exemption for exempt MTEFs is set forth in proposed new Part 36 of the CFTC regulations. If a transaction effected pursuant to Part 36 is cleared, it must be cleared by (1) a clearing organization recognized by the Commission, (2) a securities clearing agency, (3) a clearing system organized as a bank or bank affiliate, or (4) a foreign clearing organization that satisfies the Commission that it is subject to comparable regulation in its home country. (The CME's comments on the regulation of clearing organizations are set forth below.) If contracts traded on an exempt MTEF are listed on an electronic system that also lists RFE or DTF

contracts, the system must disclose that the exempt MTEF contracts are not subject to regulation under the Act.

Proposed Regulation 36.2(e) contains an additional requirement that a facility that operates a market as an exempt MTEF must be "legally separate" from any designated contract market, any RFE and any DTF. The CME believes that this requirement should be eliminated because it serves no legitimate regulatory purpose and has the potential of increasing the operating costs of a facility that offers different types of markets. We understand the Commission's desire that market participants be fully advised that different types of markets offer different degrees of regulatory protection. Indeed, as noted above, when an exempt MTEF lists its contracts for trading on an electronic system that also lists RFE contracts or DTF contracts, the system must disclose that the exempt MTEF contracts are not subject to regulation under the Act. But these disclosures can be made whether or not the exempt MTEF is incorporated as a separate legal entity. For example, the CME today operates both markets for regulated futures contracts and markets for spot commodities such as butter and cheese that are not regulated under the Act. No one has suggested that the fact that the CME operates both regulated and unregulated markets through a single legal entity has ever harmed market participants. To require exempt MTEFs to be separate legal entities would merely add an extra layer of cost and paperwork without any public benefit.

II. REGULATORY FRAMEWORK FOR CLEARING ORGANIZATIONS

The Commission is proposing a new Part 39 regulatory framework that would apply to clearing organizations. An entity can be approved by the Commission as a "recognized clearing organization" ("RCO") by demonstrating that it satisfies 14 core principles. U.S. clearing organizations that currently perform clearing services for transactions executed on domestic futures and options exchanges generally satisfy the core principles and would not be required to make any additional showing or change their method of operation.

The Commission realizes that the cash, futures, securities and options markets are converging, and that there is a growing demand for clearing organizations to be able to clear transactions in each type of market. Nothing in the Commission's proposal would prohibit an RCO from clearing any other type of cash market or derivative instrument, whether regulated or unregulated. The CME strongly supports this aspect of the Commission's proposal.

However, the CME is concerned that Part 39 may be read as expanding the scope of CFTC jurisdiction to cover all transactions that are cleared by an RCO, even if the transactions otherwise would be outside of the CFTC's jurisdiction. For example, the CME Clearing House currently clears transactions in unregulated spot markets for commodities such as butter and cheese, and the CME Clearing House is likely to offer clearing services for other unregulated spot markets on behalf of business-to-business exchanges. Transactions in such unregulated markets should not be subject to CFTC jurisdiction. Yet proposed Regulation 39.6 makes it unlawful for any person to cheat or defraud any other person in connection with "any

transaction" cleared by an RCO. In other words, a transaction that otherwise would be outside of the CFTC's jurisdiction could become subject to the CFTC's anti-fraud rule simply because it is cleared by an RCO.

The participants in the OTC derivatives markets and the business-to-business markets have made it very clear that they do not wish to subject transactions in their markets to CFTC jurisdiction. Accordingly, if there is any possibility that transactions in such markets could become subject to jurisdiction if they are cleared by an RCO, the participants would arrange to have such transactions cleared by an entity that is not an RCO. This would make it impossible for RCOs to compete for this type of business against other clearing entities that are not RCOs. We therefore urge the Commission to revise Part 39 to make it clear that transactions that are outside of the CFTC's jurisdiction do not become subject to its jurisdiction simply because they are cleared by an RCO.

A related concern is the fact that the requirements for acting as an RCO are the same regardless of the nature of the transactions being cleared. Part 39 applies to all cleared transactions, regardless of whether the transactions are effected through a designated contact market, an RFE, a DTF, an exempt MTEF or a facility for exempt bilateral transactions under Part 35. RCOs are thus subject to the same degree of regulation if they clear transactions for retail customers on an RFE or if they clear transactions for eligible institutions on an exempt MTEF. We believe that this "one-size-fits-all" regulatory model is no more appropriate for RCOs than it is for MTEFs.

Proposed Regulation 39.2(a) states that only an RCO may clear transactions effected on a designated contract market, an RFE or a DTF. The CME supports that requirement. Under proposed Regulation 39.2(b), transactions effected pursuant to Part 35 (exempt bilateral transactions) or Part 36 (exempt MTEF transactions) may be cleared by an RCO, a securities clearing agency subject to SEC jurisdiction, a clearing system of a bank or bank affiliate subject to the jurisdiction of the Federal Reserve or Comptroller of the Currency, or a foreign clearing organization that is subject to comparable regulation in its home country. We have a competitive concern with this provision. It will give clearing organizations regulated by the SEC, bank regulatory agencies or foreign regulators the ability to clear the full spectrum of financial transactions -- cash, securities, options, futures (if traded on an exempt MTEF) and other derivatives. In stark contrast, the SEC will not allow an RCO that is not also registered as a clearing agency with the SEC to clear transactions in securities. This imbalance would put RCOs at a significant disadvantage in competing with other types of clearing organizations for the business of clearing the full spectrum of financial transactions.

Under the Act and current CFTC regulations, only certain specific aspects of a clearing organization's activities are subject to regulatory requirements. Those requirements are mainly in the areas of customer segregated funds (see, e.g., Regulations 1.20, 1.25, 1.26, 1.27 and 1.29) and general regulations pertaining to self-regulatory organizations (see, e.g., Regulations 1.59, 1.63 and 1.69). When a particular regulation is intended to apply to clearing organizations, it

expressly so provides (see Regulation 1.41(a)(3), defining the term "contract market" to include a clearing organization for the limited purpose of submitting rules for Commission review). This targeted approach to the regulation of clearing organizations has worked well, and the Commission has articulated no reason for changing that approach.

However, Part 39 takes a completely different approach. Proposed Regulation 39.1(b)(2) provides that an RCO shall be deemed to be a contract market for purposes of the Act and Commission regulations thereunder. The proposed regulation then exempts RCOs from such regulations except the long list contained in proposed Regulation 39.5. In our view, Part 39 takes the wrong approach. Rather than starting with the premise that all regulations applicable to contact markets should apply to RCOs and then granting exemptions from some portion thereof, we believe it would be far preferable to continue the policy used currently of having a regulation apply to clearing organizations only when the regulation expressly so provides. In addition, we observe that Part 39 and the "guidance" set forth in Appendix A contain many regulatory requirements that do not exist in the current regulations applicable to the clearing organizations. Whereas the proposed regulatory framework for MTEFs under Parts 36, 37 and 38 lessens the regulatory burden faced by futures exchanges under the current regulatory environment, the opposite is true for clearing organizations. In the absence of some showing that the current regulatory treatment of clearing organizations is somehow inadequate, we believe that the additional requirements contained in Part 39 are not necessary.

III. PROPOSED RULES FOR INTERMEDIARIES

Under the Commission's proposal, intermediaries of transactions conducted on an exempt MTEF would be subject only to the anti-fraud and anti-manipulation provisions of the Act. Intermediaries involved in transactions that are conducted on an RFE or DTF would be subject to a more comprehensive regulatory framework in accordance with eight core principles. However, unlike the approach taken in Parts 37 and 38, the core principles for intermediaries do not generally replace the prescriptive regulations applicable to intermediaries that currently exist.

The Commission's proposal provides regulatory relief to intermediaries in a number of areas. Account opening procedures would be simplified to allow for all required disclosures (except for arbitration agreements) to be acknowledged with a single signature, which may be an electronic signature. The Commission proposes to delete Regulation 3.34, which requires CFTC registrants to attend mandatory ethics training and specifies the frequency and duration of such training, the suggested curriculum, qualifications of instructors, and the necessary proof of attendance at such classes. The Commission proposes to replace that regulation with a Statement of Acceptable Practices which affords registrants greater flexibility in designing ethics training programs to encourage the maintenance of professional ethical standards. The CME supports these proposals and urges the Commission to consider other areas in which prescriptive regulations can be replaced with more flexible core principles and statements of acceptable business practices.

A very important part of the Commission's proposal would allow firms that are already regulated by the SEC or a federal banking agency to register as an FCM or IB through a simplified registration procedure, provided that such firms conduct business in futures markets solely for institutional customers on DTFs. Such firms could register as an FCM or IB by filing a notice with the NFA, without filing CFTC registration forms and fingerprints. In addition, the individual sales persons of these firms would not be required to be registered as APs for such FCMs or IBs and would not be subject to passing the Series 3 exam. The CME supports this proposal as an important first step to allow firms that are subject to oversight by a federal regulatory authority to deal with their institutional customers in the full range of financial markets, including securities, futures, options and other derivative instruments.

However, the CME strongly opposes that aspect of the proposal that limits this regulatory relief to firms that effect futures transactions only on DTFs. As discussed above, Part 37 contains a number of restrictions for DTFs that severely limit the usefulness of that market category. For example, stock index futures contracts are not eligible to be traded on a DTF. Thus, the proposed rulemaking provides no relief whatsoever to a securities broker-dealer (not also registered as a FCM) that wishes to execute transactions in both stock index futures and the underlying stocks in order to implement an asset allocation strategy for its institutional customers. So long as the customers are sophisticated institutions, we can see no regulatory reason not to allow them to use the federally-regulated intermediary of their choice in effecting transactions in a futures market, regardless of whether the market is regulated as a designated contract market, an RFE, a DTF or an exempt MTEF.

The Commission requested comments on whether to permit the application of risk-based net capital requirements. The CME strongly supports risk-based capital requirements. The CME, in conjunction with the Chicago Board of Trade and Board of Trade Clearing Corporation, developed and implemented risk-based capital requirements in January 1998. Based on our positive experience, we found that risk-based capital requirements have the following benefits:

1. All commodity accounts and positions are included. Under the CFTC's current capital computation, the accounts of foreign customers trading foreign markets, accounts in a deficit position, and accounts depositing letters of credit for margin/performance bond purposes are not included. Thus, the risk-based approach more accurately measures the overall risk level of a firm's activities.

2. The current CFTC requirement penalizes firms for holding excess funds from their customers and non-customers and encourages firms to return such excess funds in order to lower their capital requirement. Because a risk-based approach does not depend on the amount of customer funds held, it avoids that problem and complements sounds risk management policies.

3. Risk-based capital requirements are more closely related to a firm's financing needs. A firm needs capital in order to meet daily calls for settlement and

margin/performance bond, which are measured by one-day losses on positions carried by the firm. Accordingly, a risk-based capital requirement better correlates with a firm's need for capital to meet its financing requirements.

The Commission also requested comments on whether, and under what circumstances, customers should be allowed to "opt out" of segregation. This is a large subject with many ramifications. The CME appreciates the Commission's willingness to consider changes in this area, and we welcome the opportunity to work with the Commission and the industry on a comprehensive study that would address the possible advantages and consequences of particular changes.

Regulation 1.25 sets forth the types of instruments in which FCMs and clearing organizations are permitted to invest the segregated cash of regulated commodity customers. Currently, FCMs and clearing organizations are permitted to invest segregated funds only in obligations of, or fully guaranteed by, the U.S., or in general obligations of any State or political subdivision thereof. The Commission's proposal would expand the list of permitted investments to include other specified instruments. The CME supports this proposal and agrees with the Commission that it could enhance the yield available to FCMs and their customers, without compromising the safety of customer funds. The CME also supports the addition of repurchase transactions as allowable investments of customer funds in order to increase the liquidity of segregated pools.

It is important to preserve the right of clearing organizations to establish higher (more restrictive) standards for the instruments that they will accept as collateral. Clearing organizations have different liquidity needs than FCMs. If a significant market movement generates a margin call to an FCM's customer, the firm has a grace period to collect additional margin before the event affects its capital. In contrast, clearing organizations must have immediate access to cash in order to make pays and collects on a daily basis. Accordingly, a clearing organization may legitimately insist on accepting only the most liquid forms of collateral.

IV. EXPANSION OF SWAPS EXEMPTION

The Commission is proposing to amend its Part 35 exemption for swaps transactions in order to expand the scope of the exemption and to provide greater legal certainty to the OTC markets. The major changes to Part 35 are described below:

1. Previously, the Part 35 exemption did not apply if the swap agreement was part of a fungible class of agreements that are standardized as to their material economic terms. This requirement would be eliminated under the proposal.

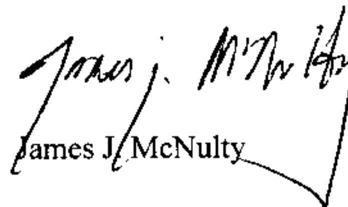
2. Previously, swap transactions that were cleared by a central clearing house were not eligible for the Part 35 exemption. The proposal would allow transactions to be cleared by a clearing organization that is authorized under Regulation 39.2.

3. In order to provide greater legal certainty, proposed Regulation 35.3(b) provides that a transaction with an eligible participant (or counterparty reasonably believed to be an eligible participant) shall not be voidable solely because of the failure of a party to such transaction to comply with the terms or conditions of the exemption.

The CME generally supports the proposed changes to Part 35, but with the following caveat. When the OTC markets are allowed to trade contracts for future delivery that are fungible, standardized and cleared by a central clearing house, it will be very difficult to distinguish between the OTC markets and the traditional exchange markets. The two types of markets will compete head-to-head in an attempt to attract institutions to participate in their respective markets.

The CME welcomes such competition provided that it is fair competition conducted on a level playing field. The CME commends the Commission for proposing a regulatory restructuring in Parts 36, 37 and 38 that would remove many of the existing constraints on exchanges' ability to compete. However, as discussed above, the Commission's proposal does not go far enough in a number of areas. As one example, agricultural futures could not be traded on a DTF even though standardized and fungible contracts with identical terms could be traded in the OTC market under Part 35. The CME urges the Commission to improve its proposal along the lines suggested in this letter. We believe that the proposed changes to Part 35 (which would enhance the competitive position of the OTC markets) should not be implemented unless and until the improved versions of Parts 36, 37 and 38 (which would enhance the competitive position of the exchange markets) are implemented as well.

Respectfully submitted,



James J. McNulty

cc: Honorable William J. Rainer
Honorable Barbara Pedersen Holum
Honorable David D. Spears
Honorable James E. Newsome
Honorable Thomas J. Erickson

CAR/jh 4680