20 South Wacker Drive
Chicago, IL 60606-7499
www.cme.com

312/930.1000 *tel*
312/466.4410 *fax*

November 9, 2006

Ms. Eileen Donovan
Acting Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

RE: Voluntary Submission of CME Credit Event Futures for Commission Review and Approval per Sec. 5c(c)(2) of the CEA and Regulation § 40.3 Thereunder.
CME Submission # 06-76

Dear Ms. Donovan:

Chicago Mercantile Exchange Inc. ("CME" or "the Exchange") made a voluntary submission of CME Credit Event Futures for Commission review and approval per section 5c(c)(2) of the CEA and Regulation § 40.3 thereunder.[1] The Chicago Board Options Exchange ("CBOE") and the Options Clearing Corp. ("OCC") (collectively, the "Objectors"), filed comment letters dated November 3, 2006, with the Commission. We are submitting this letter in response to the comment letters filed by CBOE and OCC.

I. Introduction

CME Credit Event Futures are intended to provide a means of acquiring protection against the risk of identified credit events experienced by an underlying reference entity. The binary nature of the contract arises from the method of final cash settlement. In the absence of a credit event (as defined in the contract) experienced by the reference entity, the final cash settlement is zero ($0). If the reference entity experiences a credit event, then the final cash settlement will be a non-zero amount predetermined by the contract.

[1] CME Submission #06-76 dated October 17, 2006.

Accordingly, this new futures product provides an exchange-traded alternative for hedging certain default risks (along with the benefits of exchange trading) to that of the over-the-counter derivates market. The contract's value is not based on the value of any security issued by the referenced entity and does not permit the delivery of a security (or the delivery of any measure of valued based on a single security or index of securities).

The Objectors devote much of their response to the question of whether the proposed contract is a futures contract or an option contract. That discussion is not relevant to the central question of whether CME's proposed contract is subject to the CFTC's exclusive jurisdiction. The CFTC has exclusive jurisdiction (with minor exceptions that are not pertinent) over futures, options on futures and options on commodities.[2] Swaps, which have been listed for trading on at least two futures exchange, are clearly commodities as defined by the CEA,[3] and therefore, the Commission's exclusive jurisdiction is clear, whether the product is a future or an option, unless the underlying instrument is a "security." Accordingly, we first respond to the central issue regarding the definition of "security" and then respond to the Objectors' discussion of whether the product is an option or future.

II. CME's Reply to Objectors' Comments

The CEA distinguishes between futures contracts and options *on commodities*, which are clearly within the CFTC's jurisdiction, and *security* futures products and options *on securities*, which are respectively subject to joint jurisdiction or subject to the exclusive jurisdiction of the SEC. The controlling question is whether a contract whose value depends only upon the occurrence or non-occurrence of a defined default event respecting the underlying reference entity can be characterized as a security. The answer to this question begins (and in this case, ends) with the statutory construction of the relevant statutes.[4] The Objectors cite section 2(1) of the Securities Act of 1933 and section 3(a)(10) of the Securities Exchange Act of 1934, which define "security" under the CEA,[5] but they studiously fail to discuss the definition of "security" set out in those sections.

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[2] Section 2 of the CEA sets forth the CFTC's jurisdiction as follows: "The Commission shall have exclusive jurisdiction, except to the extent otherwise provided in subparagraphs (C) and (D) of this paragraph and subsections (c) through (i) of this section, with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid','offer', 'put', 'call', 'advance guaranty', or 'decline guaranty'), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated or derivatives transaction execution facility registered pursuant to section 7 or 7a of this title or any other board of trade, exchange, or market. . . ."

[3] Section 1a of the CEA defines "Commodity" as follows: "The term 'commodity' means . . . all other goods and articles, except onions as provided in section 13-1 of this title, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."

[4] *E.g.*, Leocal v. Ashcroft, 543 U.S. 1, 8 (2004) (statutory interpretation "begins with the language of the statute").

[5] *See* section 1(a)(3) ("The term 'security' means a security as defined in section 2(a)(1) of the Securities Act of 1933 (15 U.S.C. 77b(a)(1)) or section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(10)).").

Section 3(a)(10) of the 1934 Act is representative and provides:

> Section 3 -- Definitions and Application. . . .
>
> 10. The term "security" means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

The definitions of “Security Futures” and “Security Futures Products” also rely directly on the definition of “security” as follows:

> Section 1a (31) Security future
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> The term “security future” means a contract of sale for future delivery of a single security or of a narrow-based security index, including any interest therein or based on the value thereof, except an exempted security under section 3(a)(12) of the Securities Exchange Act of 1934 [15 U.S.C. 78c(a)(12)] as in effect on January 11, 1983 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 [15 U.S.C. 78c(a)(29)] as in effect on January 11, 1983). The term “security future” does not include any agreement, contract, or transaction excluded from this chapter under section 2(c), 2(d), 2(f), or 2(g) of this title (as in effect on December 21, 2000) or sections 27 to 27f of this title.
>
> Section 1a (32) Security futures product
>
> The term “security futures product” means a security future or any put, call, straddle, option, or privilege on any security future.

Clearly there is nothing in the definition of a security in the 1933 or 1934 Acts which corresponds to the interest represented by the proposed contract. The purchaser of the futures contract does not acquire an ownership interest in the underlying corporation or any of the corporation's securities. CME's proposed contract is not based on the value of any security issued by the reference entity. The seller of the contract undertakes no obligation to deliver a security or to make a payment based on the value of a single security or some basket of securities.[6] The interest represented by the contract meets none of the judicial tests regarding an investment in a common enterprise.[7]

The Objectors attempt to divert attention from the relevant issue of the definition of a security by instead claiming, without citation or explanation, that the CEA prohibits options whose value may somehow be related to the fortunes of a public company. Aside from assuming that CME's product is in fact an option (a point CME disputes below), we note here that the CEA precludes futures exchanges only from listing options on *securities* – not options whose value may depend on corporate events or economic events that directly impact companies.[8]

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[6] Section 2(a)(1) of the Securities Act of 1933 offers the SEC some leeway to expand the definition to include, "in general, any interest or instrument commonly known as a 'security.'" This catch-all is not relevant. There is no legitimate basis to argue that a binary or digital event futures is "commonly known as a 'security.'" In fact, as noted below, Congress had determined that such contracts are not securities.

[7] *SEC v. W.J. Howey Co*., 328 U.S. 293 (1946).

[8] None of CBOE's citations are to the contrary. CBOE cites *Caiola v. Citibank, N.A*., 295 F.3d 312 (2d. Cir. 2002), in attempting to relate CME's new product to "cash settled options based on the price or value, or other features, of a specified security." See CBOE Cmmt., at 4. *Caiola* lends no support to the Objectors here. The court expressly pointed out that *Caiola* involved the "question of whether a cash-settled over-the-counter option on Philip Morris stock – similar to options commonly traded on the market – is an option on a security." *Caiola* at 326. That is hardly the case here, where the contract has no resemblance to "options commonly traded on the market" and whose payout structure – unlike the options in *Caiola* – is fully known at the time of contracting to both participants and which, in any event, is based upon pre-specified credit events and not the fluctuating market price or value of any security. CBOE's cite to *In the Matter of Gary S. Missner*, Sec. Exch. Act Rel. No. 37,301 (June 11, 1996), is equally off-base. As an initial matter, *Missner* is not a court opinion but rather a release of the SEC in which the SEC expressly noted that "[t]he findings herein are made pursuant to Missner's Offer of Settlement and are not binding on any other person or entity named as a respondent in this or any other proceeding." *Id.* n1. Be that as it may, the "cash-settled put option" in *Missner* has none of the binary event attributes that characterize CME's product. Far from it, the "increasingly complex, risky and intertwined" options in *Missner* were based upon a fluctuating market price-yield spread of two Treasury securities that "had leverage factors which caused [the purchaser's] losses to increase dramatically with relatively small changes in interest rates." *Id*. at 1. CBOE struggles mightily in attempting to link CME's product to the fluctuating market price or value (including yield) of corporate debt securities. The fact is that there is no reference security in the case of CME's product. Moreover, nowhere in CBOE's convoluted explanation does it even attempt to address the relevant issue here, namely, whether contracts with binary payoffs based upon pre-specified credit events may be characterized as securities under the relevant statutes (they cannot). *Missner* and CBOE's related discussion are plainly irrelevant to that issue.

A proxy for the fortunes of many enterprises can be assembled by means of futures and options on the inputs, outputs and demand factors that directly impact profitability. Surely the Objectors are aware that the oil "crack spread" and the soybean "crush" can serve that function in respect of certain processors. Similar indexes and spreads are applicable to financial firms. Moreover, in a somewhat bizarre turn-about in its position, the Objectors concede that CME's proposed contract is an option on a non-security if it is based on a swap that qualifies for exclusion under the CFMA.[9] While the Objectors assert that CME's proposed contract is not based on a swap that qualifies for an exclusion, they fail to explain this assertion, which is plainly wrong.

In any event, CME's proposed product does represent binary, event swaps where the "event" is a defined credit event experienced by the reference entity. The contract does not provide for future delivery of a single security or for delivery of any measure of value based on a single security or an index or basket of securities. The payout is fixed in advance of listing the contract and does not vary in relation to the price of any security of the referenced entity. If the contract were traded OTC and its terms were subject to individual negotiation, it would be classified as a non-security based swap agreement under section 206C of GLB.

Accordingly, the underlier for the CME contract is not a security. It is a hypothetical cash settled, single reference entity, binary credit default swap. The proposed contract provides a hedging mechanism for lenders and others doing business with the reference entity who might be adversely affected by a default by the reference entity. The Objectors correctly concede that this instrument would constitute a non-security based swap agreement if it were traded over-the-counter between qualified parties. The SEC has no jurisdiction, including no antifraud or insider trading jurisdiction, over non-security based swap agreements.

Moreover, the definitions of security-based and non-security-based swap agreements were adopted as amendments to the Gramm-Leach-Bliley Act (Public Law 106–102) ("GLBA"), which were part of the legislative package that included the CFMA.[10] The purpose of the distinction between "security-based" and "non-security-based" was to limit the SEC's antifraud jurisdiction to security-based swap agreements. In consequence, the SEC has no jurisdiction over, and is statutorily precluded from basing, an insider trading case on the purchase or sale of a non-security-based swap agreement. The definitions clearly place certain credit event swaps, as defined in section 206A(a)(2), in a separate class from security-based swaps, Compare sections 206A(a)(2) and (a)(3) below. The relevant definitions, which are incorporated by reference in the securities laws, are as follows.

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[9] According to CBOE, "[i]f the CME Product qualified as a 'swap agreement' under the CFMA, it would be excluded from the definition of a security under the securities laws. Similarly, if it were based on a swap that qualified for this exclusion, it would be an option on a non-security that would not itself be a security. However, because neither the CME Product nor its underlyer can meet the criteria specified in the CFMA, the CME Product cannot be characterized as an option on a non-security and must therefore be treated as a security." Joanne Moffic-Silver, CBOE, letter to Eileen Donovan, CFTC, dated November 3, 2006, p. 7.

[10] "TITLE III—LEGAL CERTAINTY FOR SWAP AGREEMENTS, SEC. 301. SWAP AGREEMENT. (a) AMENDMENT.—Title II of the Gramm-Leach-Bliley Act (Public Law 106–102) is amended by inserting after section 206 the following new sections", PUBLIC LAW 106–554—APPENDIX E, 114 STAT. 2763A–449.

SEC. 206A. SWAP AGREEMENT.

(a) IN GENERAL. - Except as provided in subsection (b), as used in this section, the term "swap agreement" means any agreement, contract, or transaction between eligible contract participants (as defined in section 1a(12) of the Commodity Exchange Act as in effect on the date of the enactment of this section), other than a person that is an eligible contract participant under section 1a(12)(C) of the Commodity Exchange Act, the material terms of which (other than price and quantity) are subject to individual negotiation, and that -

(1) is a put, call, cap, floor, collar, or similar option of any kind for the purchase or sale of, or based on the value of, one or more interest or other rates, currencies, commodities, indices, quantitative measures, or other financial or economic interests or property of any kind;

(2) provides for any purchase, sale, payment or delivery (other than a dividend on an equity security) that is dependent on the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence;

(3) provides on an executory basis for the exchange, on a fixed or contingent basis, of one or more payments based on the value or level of one or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred, including any such agreement, contract, or transaction commonly known as an interest rate swap, including a rate floor, rate cap, rate collar, cross-currency rate swap, basis swap, currency swap, equity index swap, equity swap, debt index swap, debt swap, credit spread, credit default swap, credit swap, weather swap, or commodity swap;

(4) provides for the purchase or sale, on a fixed or contingent basis, of any commodity, currency, instrument, interest, right, service, good, article, or property of any kind; or

(5) is any combination or permutation of, or option on, any agreement, contract, or transaction described in any of paragraphs (1) through (4).

SEC. 206B. SECURITY-BASED SWAP AGREEMENT.

As used in this section, the term "security-based swap agreement" means a swap agreement (as defined in section 206A) of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein.

> SEC. 206C. NON-SECURITY-BASED SWAP AGREEMENT.
>
> As used in this section, the term "non-security-based swap Agreement" means any swap agreement (as defined in section 206A) that is not a security-based swap agreement (as defined in section 206B).

The GLBA definitions exclude from the definition of a security-based swap agreement a credit event swap that is not based on the "price, yield, value, or volatility of any security or any group or index of securities, or any interest therein." If the swap or a futures contract defines the event in terms that do not relate to price or value of any security or group of securities, as CME has done in this case, the statutory definition confirms that an event futures contract is not based on a security.

The GLBA and securities law amendments respecting non-security-based swaps confirm congressional policy that the SEC's jurisdiction does not extend to every instrument that relates to the success or failure of a business. SEC jurisdiction only attaches when a security or a security-based swap is involved. For example, if a Cargill employee speculates in wheat futures based on inside information regarding Cargill's business, the SEC cannot bring an insider trading case. Wheat futures do not become security futures because they can be used to exploit inside information. Corporations and shareholders have adequate remedies at common law (*e.g.,* claims for breach of fiduciary duty) to prosecute an insider who misuses corporation information.

III. CME Credit Event Futures Are Not Options.

Notwithstanding the fact that the central issue for the Commission's review is whether CME's product invokes the statutory definition of "security" (it does not, as discussed above), CME does not agree with the Objectors' assertion that "[t]he CME Product is an Option and not a Futures Contract." Objectors invoke an "economic reality standard" to distinguish the two classes of derivatives.[11]

The Objectors point to the risk structure of CME's proposed contract and conclude that it has the same characteristics as an option, noting in particular that participants holding a long position in the product assume limited or bounded risk. The Objectors do not point out, however, that options – while limiting the risk faced by the purchaser to the purchase price of the option – do not normally limit the purchaser's profit potential. That is, the purchaser's risk is limited to the price of the option while his upside potential – any exercise price above the strike price – is theoretically unlimited. Conversely, the seller of an option is subject to unlimited risk (*i.e.*, a payout equivalent to the difference between the market price and the strike price) with profit potential limited to the price of the option.

[11] Joanne Moffic-Silver, CBOE, letter to Eileen Donovan, CFTC, dated November 3, 2006, p. 7.

The risk structure of CME Credit Event Futures, however, implies bounded risk and bounded profit potential on the part of both the long and short. Indeed, if bounded risk on the part of the long were the distinguishing feature of an option, then all futures contracts might be regarded as options to the extent that the logical lower bound of most futures contracts is zero, conceding the low probability of achieving such extreme result. CME Eurodollar futures represent an exception. Because the contract is quoted per the IMM Index, *i.e.,* at (100–Yield), the long accepts bounded upside potential with unbounded downside risk. As such, there is precedent to constrain downside or upside potential associated with long, as well as short, futures positions.

Moreover, as their label suggests, options imply a certain degree of optionality. Upon payment of the premium, option buyers assume rights but no obligations; option sellers assume an opposite risk profile. While some options operate pursuant to an auto-exercise feature, such a feature may generally be overridden at the discretion of the buyer. Buyers and sellers of CME Credit Event Futures enjoy no such optionality.

Ultimately, the Objectors' attempt to rely upon the probability of achieving bounded outcomes cannot rightly be used to distinguish futures and option contract constructions. The dividing line between options and futures has blurred as a consequence of financial innovation. The Objectors' effort to draw a bright line distinction has no support in logic or the literature. Thus, we assert that CME Credit Event Futures are most aptly characterized as a cash-settled index futures contract tied to a digital index (digital in the extreme, *i.e.,* binary) upon final settlement.

IV. Conclusion

The Objectors' comments focus on whether CME's new product is an option, intimating that if it is, then it must be an option on a security. CBOE's and OCC's comments serve largely to obfuscate the controlling issue, which is whether the CME Credit Event Future is properly characterized as an option on a security or a security futures product. No cogent argument is offered by the Objectors that the subject of the option or futures contract is a security.

CME appreciates the opportunity to respond to CBOE's and OCC's comments. Please do not hesitate to contact me at 312-466-7469 or via e-mail at jlab@cme.com; or, Mr. Jerry Salzman, at 312-222-5131 or jsalzman@ffspc.com, if we can provide any additional information. We would be most appreciative if you could reference CME Submission #06-76 in any such correspondence.

Sincerely,

John W. Labuszewski, Managing Director
Research & Product Development