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December 11, 2006

Ms. Eileen Donovan
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre, 1155 21st Street, NW
Washington, DC 20581

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

Dear Ms. Donovan:

Chicago Mercantile Exchange ("CME" or "the Exchange") made a voluntary submission of CME Credit Event Futures for Commission review and approval per § 5c(c)(2) of the CEA and Regulation § 40.3 thereunder.[1] The submission was published for public comment and the Chicago Board Options Exchange ("CBOE") and the Options Clearing Corp. ("OCC") responded.[2] CME responded to those comments, and CBOE has now submitted a further letter to the Commission with additional comments.[3] We submit this letter in response to CBOE's additional comments.

I. CME's Proposed Futures Contracts Are Not "Securities"

CME pointed out in its response to CBOE's and OCC's initial comments that they had failed to discuss the definition of "security" under the federal securities laws and failed to make any case that CME's proposed credit event futures contract fell within that definition. Their failure to discuss the definition of a security was a critical omission because a determination that CME's proposed contract is *not* a security is dispositive in determining that the contract *is* subject to the CFTC's exclusive jurisdiction.

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[1] CME Submission # 06-76 dated October 17, 2006.
[2] CME Submission # 06-76 dated November 9, 2006; *see also* CBOE Submission dated November 3, 2006 and OCC Submission # 06-76 dated November 3, 2006.
[3] CBOE Submission dated December 5, 2006.

CBOE's latest comments are an unsuccessful attempt to cure its initial omission. Indeed, CBOE fails to cite a single case or to provide a single example to support its claim that a contract characterized by a binary payout, fixed in advance of listing, which does not vary in relation to the price of any obligation issued by the reference entity (i.e., CME's proposed contract) could possibly be deemed a security under the federal securities laws.

CBOE states that its "legal position is clear, unequivocal and mandated by the [federal securities laws]" and that "an option is a security if it either provides for physical delivery of a security or, in the case of cash-settled options, the payment requirement, or the amount of such payment, are determined in whole or party by reference to one or more specified securities or one or more securities of an identified issuer."

As an initial matter (and as discussed further below), CME does not agree with CBOE's characterization of CME's proposed contract as an option. Be that as it may, CBOE's new comments simply ignore the analysis CME has already provided to the Commission in its previous letter. CME established in its response to CBOE's initial comments that there is no "physical delivery" under the proposed contract. CBOE's continued reference to physical delivery is therefore irrelevant.

As for CBOE's reference to "cash-settled options," CME addressed this point as well (at length) in its previous comments. *See* CME Cmmt., at 4 n.8. CBOE had cited *Caiola v. Citibank*, N.A., 295 F.3d 312 (2d Cir. 2002), and *In the Matter of Gary S. Missner*, Sec. Exch. Act Rel. No. 37,301 (June 11, 1996), in arguing that CME's proposed contract had the characteristics of cash-settled options. The discussion in CME's response made clear that these cases cannot be compared in any meaningful manner to the facts at issue here, and it is therefore not surprising that CBOE did not attempt to resurrect those cases in its new set of comments.

Instead, CBOE cites two additional cases – *Reves v. Ernst & Young*, 494 U.S. 56 (1990), and *Tcherepnin v. Knight*, 389 U.S. 332 (1967) – in arguing that "the emphasis must be on the 'economic reality' of the instrument, rather than on mechanical tests or criteria." (CBOE previously invoked the "economic reality" test for its separate argument that CME's product is an option rather than a future.)

Other than merely citing those two cases (without page citations), CBOE says nothing further about them – and it is no surprise why. Much like the cases CBOE cited in its first set of comments, *Reves* and *Knight* have no bearing upon CME's proposed contract.[4] For instance, unlike the value of the contracts at issue in *Reves* and *Knight*, the binary payouts under CME's proposed futures contracts are specified at the outset of contracting and are linked to identifiable credit events, not to the value or change in value of any security.[5] CBOE remains silent on this obvious – but critical – factual difference in the cases it cites. Moreover, *Reves* and *Knight* fail to provide any substance to the "economic reality" proposition for which CBOE cites them. The handful of references to "economic reality" in those cases are generic and do not speak to the attributes of the contracts at issue here (*i.e.*, binary and pre-specified payouts based upon known credit events). The cited cases are simply inapposite to the CFTC's review.

CBOE also suggests that the "Final Settlement Rate," which is specified in the documentation CME submitted in support of its proposed product-offering, is tied to the pricing of the underlying securities of the reference entity. In particular, CBOE claims that the Final Settlement Rate "clearly represents an estimated recovery rate on an underlying security of the Reference Entity." It also cites CME's initial filing, which referenced "recovery rate" as a pricing factor for credit default swaps. CBOE's discussion is both misleading and misguided.

As an initial matter, the reference to "recovery rate" in CME's initial filing was part of a general discussion of credit default swaps included in the filing pursuant to Commission Regulation § 40.3(a) and did not address the specific attributes of CME's product. Therefore, CBOE wrongly relies upon the discussion of recovery rate in its attempt to link the Final Settlement Rate to a "loss rate" and, ultimately, to the pricing of the underlying securities of the reference entity. Section 2 of CME's initial filing, on the other hand, is addressed to CME's proposed product and clearly shows the Final Settlement Rate to be a fixed percentage specified in the contract and known to the parties prior to entering a contract.

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[4] In *Reves*, the Supreme Court focused narrowly upon the treatment of "notes" under the definition of securities in the Securities Exchange Act of 1934. The contracts at issue in the case were unregulated demand notes for an agricultural co-op having 23,000 members. CBOE gives no reason why it cited the case, other than its reference to "economic reality," but that term shows up only generically in the case and the court ultimately adopted a form of the Second Circuit's "family resemblance" test. *See* 494 U.S. at 64-65. In any event, there is no resemblance between *Reves* and this case. CBOE fares no better with *Tcherepnin v. Knight* (1967), another Supreme Court case. That case was the first to construe "security" as it shows up in the 1934 Act. Again, the security at issue has no resemblance to the pre-specified binary payoff under CME's proposed contract. To the contrary, the Court in *Knight* was concerned with "withdrawable capital shares" in a savings association. There were 5,000 investors in such shares, and the amount of the payoff (in the form of a dividend) was tied directly to the amount of profits of the savings association. Moreover, each investor received one vote for each $100 of withdrawable capital. The Court had "little difficulty fitting withdrawable capital shares … into [the] expansive concept of security," namely, "investment contracts" as such contracts were considered in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The single reference to "economic reality" in the case was for the basic proposition that form is disregarded over substance. CBOE's task here, however, is not establishing that basic proposition, but rather demonstrating how the binary, pre-specified payout under CME's proposed contract could somehow fit logically within the definition of security. CBOE continues to remain silent on that point.

[5] *See* note 4 *infra*.

Accordingly, the value of the contract, in the event of a covered credit event, is established in advance, without reference to any "recovery rate," real or imagined, of any security. Any change in the value of the futures contract based on perceptions respecting the likelihood of a credit event is based on the predetermined contract value set by CME and is not linked to the value or pricing of the underlying securities of the reference entity.

Finally, it is worth noting a point that CBOE fails to mention in either of its comment letters to the CFTC, which is that CBOE has itself submitted an application to the SEC for approval of a nearly identical contract referred to as a "Credit Default Option."[6] Purchasers of this proposed product would "receive a *fixed* cash payment equal to $100,000 per contract" upon confirmation of a credit event. CBOE Appl., at 13 (emphasis supplied). CBOE further explains that, "[g]iven the binary nature of the product, a benefit of Credit Default Options are that the purchaser and writer of the options will know the expected return *at the time the contract is entered*." *Id*. (emphasis supplied). Accordingly, the payout under CBOE's proposed product – like CME's futures contract – is not tied to the price fluctuations of any securities of the reference entity.

II. Futures Contracts on Credit Event Swaps

CME's response to CBOE's initial comments referenced certain sections of the Gramm-Leach-Bliley Act ("GLBA") defining "security-based swap agreement" and "non-security-based swap agreement." That discussion served to make clear that security-based swap agreements do not include credit event swaps that are similar to the one at issue here. *Compare* GLBA § 206A(a)(2) *with* GLBA § 206B; *see also* GLBA § 206C. Indeed, CBOE has already conceded that CME's product would constitute a non-security-based swap if it were traded over the counter by qualified parties.

CBOE does not withdraw its admission that a future on a binary credit event swap is not a security; instead it argues that the swap must be specifically identified. It fails to explain the source of that requirement. CBOE concedes that a binary credit event swap traded in the OTC market is not a security, but it offers nothing to suggest that trading an instrument that has the exact same value and payment characteristics on the facilities of a designated contract market converts it into a security. Whether traded OTC or on an exchange, the instrument has no characteristics of a security.

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[6] *See* "Proposal to list and trade Credit Default Options," File No. 2006-84, CBOE Submission to SEC dated October 26, 2006.

Finally, CBOE claims that CME "has conceded that the CME Product is an option." Here is what CME actually said: "CME does not agree with [CBOE's] assertion that 'the CME Product is an Option and not a Futures Contract.'" CME Cmmt., at 7 (brackets omitted). CME explained that the risk structure of its proposed contract is most aptly captured by a futures contract, and CME has not changed its position on this point. CME referenced the obvious facts that, unlike typical options, the CME product limits the upside potential of the buyer and there is no optionality feature in the contract. This is not to say that the product has no similarities to *any* type of option, as some options fall into a gray area for the purpose of characterizing them either as an option or as a future. Rather, taken as a whole CME believes its product is best viewed as a futures contract.

III. Conclusion

For the foregoing reasons, CME does not believe that CBOE's new set of comments cure the defects of CBOE's initial set of comments and are instead another (unsuccessful) attempt to obscure the fact that CME's product simply cannot be deemed a security under the federal securities laws.

CME appreciates the opportunity to respond to CBOE's additional 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