CME Group

The CFTC's Proposed 85% Rule: Less Innovation, Higher Cost, Exporting Price Discovery and Increasing Systemic Risk

I. Executive Summary

The Commodity Futures Trading Commission ("CFTC" or "Commission") released a proposed rulemaking on December 22, 2010 (Proposed Regulation 38.502 – Minimum Centralized Market Trading Requirement) that, amongst other provisions, would require that a minimum of 85% of volume in futures and options contracts be conducted on the centralized market (the "85% Rule"). Thus, this Rule would limit "ex-pit" or non-competitive transactions (*e.g.*, block trades and exchange-for-physical transactions) to no more than 15% of total volume in such contracts.[1] The CFTC's proposal would force futures and options contracts exceeding the 15% threshold off of the listed exchange and onto either a swap execution facility ("SEF") or into the over-the-counter ("OTC") market. The Commission's stated rationale is to "balance the goal of protecting the price discovery process of trading in the centralized market, with the goal of allowing off-exchange transactions for bona fide business purposes."

The CFTC's 85% Rule is arbitrary, not required by The Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA"), and would result in the following unintended negative consequences:

- hindering the ability of U.S. futures exchanges to successfully develop new products
- incentivizing U.S. futures exchanges to list new products outside the U.S.;
- forcing mature and liquid futures contracts off of exchanges and onto SEF or OTC venues;
- increasing margin requirements for "reclassified contracts" by over 200%;
- creating market risk and adverse regulatory and tax consequences for market users;
- limiting access to "reclassified" contracts because only Eligible Contract Participants ("ECPs") may trade on SEF or OTC venues; and
- adversely impacting the CME ClearPort® offering, increasing systemic risk and reducing liquidity in U.S. energy futures.

For the reasons discussed below, the CFTC should abandon this arbitrary test and let exchanges, SEFs and market participants determine, through market forces, how any derivative instrument should be listed and traded. No public benefit is gained by one-size-fits-all rules, whether set by DCMs or the Commission. Indeed, every market is different and the value of the core principles regime is that it allows each registered entity the flexibility to tailor rules to fit the characteristics of the various products it lists and makes available for trading. So long as a DCM makes a good faith effort to support and develop an open and competitive market, it should be deemed to have fulfilled its obligations under Core Principle 9 to "provide a competitive, open and efficient market and mechanism for executing transactions."

[1] An ex-pit transaction is one which is executed in a context apart from the traditional open outcry or electronically traded central limit order book ("CLOB") environments. These transactions include block trades and Exchanges for Related Positions ("EFRPs" or more commonly referred to as "EFPs"). CME Rule 538 defines ERRPs a transaction consisting "of two discrete but related simultaneous transactions. One party to the EFRP must be the buyer of (or the holder of the long market exposure associated with) the related position and the seller of the corresponding Exchange contract. The other party to the EFRP must be the seller of (or the holder of the short market exposure associated with) the related position and the buyer of the corresponding Exchange contract." However, there are several recognized varieties of EFRPs including Exchange for Physical ("EFPs"); Exchanges for Risk ("EFR"); and, Exchanges of Options for Options ("EOOs"). An EFP entails matching a futures position with an offsetting related cash position; an EFR matches futures with an OTC instrument; while an EOO matches an Exchange option position with an offsetting OTC option. But they are all collectively referred to as EFRPs per Exchange Rules.

II. Overview and Summary of Legislative History

Swap and futures contracts can be designed to replicate the same economic exposure to an underlying instrument, commodity or asset – making them indistinguishable in material economic effect for the user. Congress confirmed this fact in Dodd-Frank provisions that now codify equivalent regulatory treatment for futures and "economically equivalent" swaps. *See* e.g., Commodity Exchange Act ("CEA") 4a(a)(5). Such equivalency makes it extremely difficult, if not impossible, to separately define and categorize economically-equivalent swaps and futures. That swaps and futures can be economic equivalents is not new and has existed for decades. Historically, however, swaps were distinguishable from futures in the following manner:

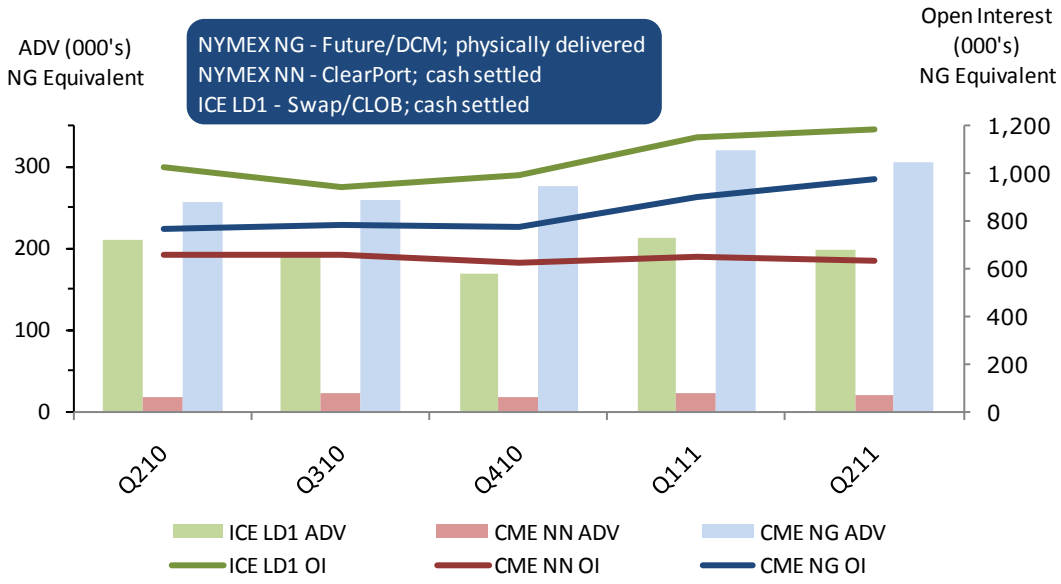
	Swaps	Futures
Degree of Standardization	Lack of standardization; negotiability of material terms	Fully standardized across all terms and conditions
Trading Model	Privately negotiated among sophisticated investors	Mainly centralized trading on an exchange
Regulatory Framework	Largely exempt from regulation within OTC space	Comprehensively regulated
Credit Model	Generally entail bilateral counterparty credit exposures	Centralized clearing model with clearing house guarantee.

CFTC Regulations, reinforced by exemptions enacted by the Commodity Futures Modernization Act of 2000 ("CFMA") further blurred the line between swaps and futures. CFMA permitted futures on certain commodities to be traded between ECPs in the OTC market. CFMA also permitted so-called swaps to be traded on electronic markets and centrally-cleared, but not intermediated. Significantly, nothing in CFMA limited exchanges' ability to list for trading futures products that mimicked non-exchange "swap" products and vice versa.

An example of the convergence between futures and swaps facilitated by CFMA is ICE's LD1 natural gas swap contract, depicted in Table 1 below. LD1 is a swap contract that is based on and prices off of NYMEX's physical delivery Henry Hub Natural Gas futures contract ("NG"). Both trade in a central limit order book environment, both are considered by the CFTC to be liquid "price discovery contracts" and both are centrally-cleared in the same manner as most actively-traded futures contracts; however, ICE's LD1 swap contract is traded as a swap on an Exempt Commercial Market whereas, NYMEX's NG futures contract trades on a designated contract market.[2]

[2] NYMEX also lists for trading a cash-settled version of NG, NN. Like NG, NN is a futures contract. Unlike NG, significant NN volume is transacted by bilateral trades.

Table 1: Trading Activity in Contracts Supporting Natural Gas Price Discovery



The market turmoil and financial crisis of 2008 highlighted the benefits of central counterparty clearing systems – long employed in the regulated futures markets – and the dangers of overreliance on bilateral OTC markets. Throughout the financial crisis, CFTC-regulated futures exchanges and clearing houses operated flawlessly, performing all of their essential functions without interruption. Indeed, while large financial firms regulated by other oversight agencies failed, CME Group's clearing house experienced no default and no customers on the futures side lost their collateral.

In response to the financial crisis, Congress enacted DFA in July 2010. Among other things, DFA is aimed at reducing systemic risk in OTC markets through central counterparty clearing and by increasing the transparency, liquidity and efficiency in OTC markets. To achieve these objectives, DFA established a new regulatory regime similar to that which exists for CFTC-regulated futures exchanges and their market participants, one that arguably mirrors the direction in which a number of OTC markets were headed under CFMA. In essence, DFA requires that standardized OTC products be cleared by a central counterparty and executed on a futures exchange or a SEF. DFA also establishes a comprehensive reporting regime for swaps and imposes enhanced prudential regulations on persons and entities trading those products.

With the amendments to the CEA by DFA, virtually all significant distinctions between futures and swaps have been eliminated. DFA, however, preserves "customer choice." That is, under DFA, market participants retain the option to trade products as either "futures" or "swaps"; in the case of an ECP, DFA allows market participants to choose the execution venue for trading swaps (with certain limitations). DFA does not – either in letter or spirit – force market participants out of the futures market and into the swaps market, or vice versa.

III. The CFTC's Proposed Rule Capping Trades Outside the Centralized Market

Core Principle 9 for DCMs – Execution of Transactions – states that a DCM "shall provide a competitive, open and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market." Core Principle 9, however, expressly authorizes transactions outside the centralized market so long as those transactions are executed pursuant to DCM rules.

Specifically, Core Principle 9 provides that "the rules of a board of trade may authorize . . . (i) transfer trades or office trades; (ii) an exchange of (I) futures in connection with a cash commodity transaction; (II) futures for cash commodities; or (III) futures for swaps; or (iii) a futures commission merchant, acting as principal or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if that contract is reported, recorded, or cleared in accordance with the rules of the contract market or [DCO]." In fact, amended Core Principle 9 explicitly recognizes that transactions on a DCM – whether futures or swaps – may be executed privately and bilaterally in order to serve a "bona fide business purpose."

In conflict with the plain terms of Core Principle 9, CFTC proposed rule 38.502(a) would require that 85% or greater of the total volume of any contract listed on a DCM be traded on the DCM's centralized market, as calculated over a 12 month period. Specifically, in relevant part, proposed rule 38.502 provides that no DCM "may continue to list a contract for trading unless an average of 85% or greater of the total volume of such contract is traded on the designated contract market's centralized market, as calculated over a 12 month period". This proposed rule would apply to contracts that are listed as of the effective date of the rule and any products listed after the effective date of the rule. If a contract fails this test, the DCM is required to delist the contract and transfer the open positions in the contract to a SEF (either one it operates or one operated by another entity) or require market participants to liquidate the contract within 90-days of performing the requisite calculation.

There will be significant adverse consequences for exchanges and market participants if this rule is adopted, yet there is no regulatory or public benefit from such rule. Access to the newly-styled "swap contract" on the SEF is limited to ECPs, prohibiting many potential customers with an interest in such product from trading the product. Disrupting the market in this manner will, among other things, artificially constrain the development of liquidity in affected products, harming customers in a manner that is directly contrary to the very purposes of the CEA and the mission of the CFTC. To be sure, other CFTC proposed rules would require margin levels for the reclassified "swap" contract to be significantly greater and would be set based on the execution venue, not the liquidity characteristics and referential pricing reliability for such product. Moreover, cross-margin benefits currently favoring customers who maintain open interest in both types of products likely would be significantly reduced or eliminated in some circumstances because of the above-referenced margin rule and the lack of clarity as to how swap and futures cross-margining will work given that there are separate account classes and rules governing collateral for futures and swaps. Finally, there may be market risk and adverse tax and regulatory consequences for market participants as a result of being forced into the swaps market. We discuss these issues in detail below.

IV. Unintended Adverse Consequences of the CFTC's Arbitrary Rule

1. **The 85% Rule will hinder the ability of exchanges to successfully develop new products.** The CFTC's arbitrary 85% test will significantly deter the development of new products by existing exchanges like CME Group, and furthermore deter any new futures exchanges from being established. New futures products often initially build open interest and gain trading momentum in exchange sanctioned non-competitive transactions, and in many instances, it takes years before trading on the centralized market becomes the predominant mode of trading. Based on our internal studies on new product performance, we have found that, on average, it sometimes takes as long as 36 months for new products to "achieve traction," which is defined as average daily volume ("ADV") > 1,000 contracts.[3] Specifically, the study showed that:

    - Agricultural Commodity and FX Products follow the overall trend, although their growth from months 6 to 36 is less pronounced so it takes them longer on average to achieve traction.

[3] To be clear, "achieving traction" does not mean that the product would pass the 85% test.

- Equity and Interest Rate products exhibit above-average growth and generally need less time to achieve traction.
- Alternative investment products exhibit sporadic growth, possibly due to their reliance on seasonal factors like weather and their lack of correlation with existing successful products.

During the introductory stage, a product is novel and volume may be slow. Marketing efforts may be extremely important in prompting customers to try the product. In the context of futures or other derivatives, the participation of market makers is paramount in "jump-starting" these products. This market making activity may be facilitated through electronic trading portals such as CME Globex® or through ex-pit transactions, which essentially represent a means through which customers may enter a "request for quote" ("RFQ") to be privately negotiated and executed.

Flexible block and EFP rules may be extremely helpful in sustaining nascent markets as they traverse the various product lifecycle stages, mustering liquidity in the process. But this process is very uneven across markets. Many, if not most, novel contracts fail to get past the introductory stage and may be delisted. As indicated in Tables 2 and 3 below, during the introductory stage of new contracts such as CBOT 5-Year Swap Futures and CME Ethanol Futures, the proportion of non-competitive trading activity may be relatively high, often in excess of the arbitrary 15% limit on such transactions.

Table 2: CBOT 5-Year Swap Futures – Total Volume and % of Ex-Pit Volume

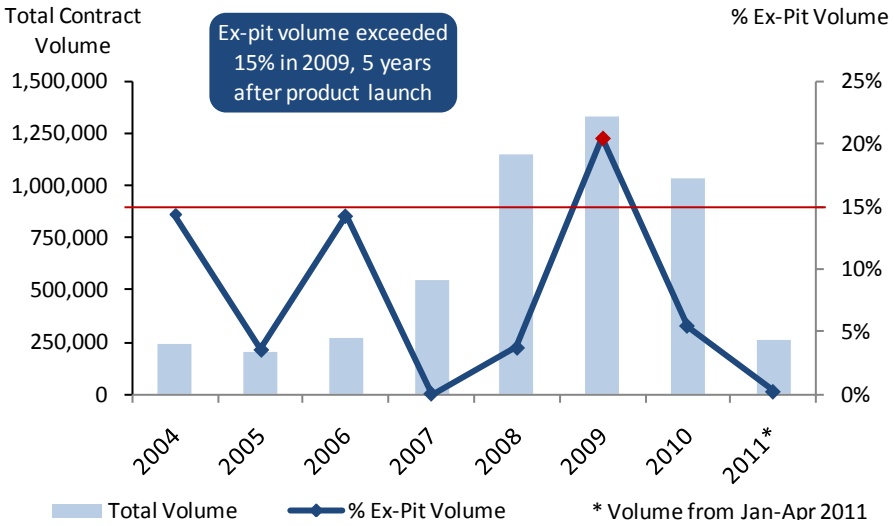
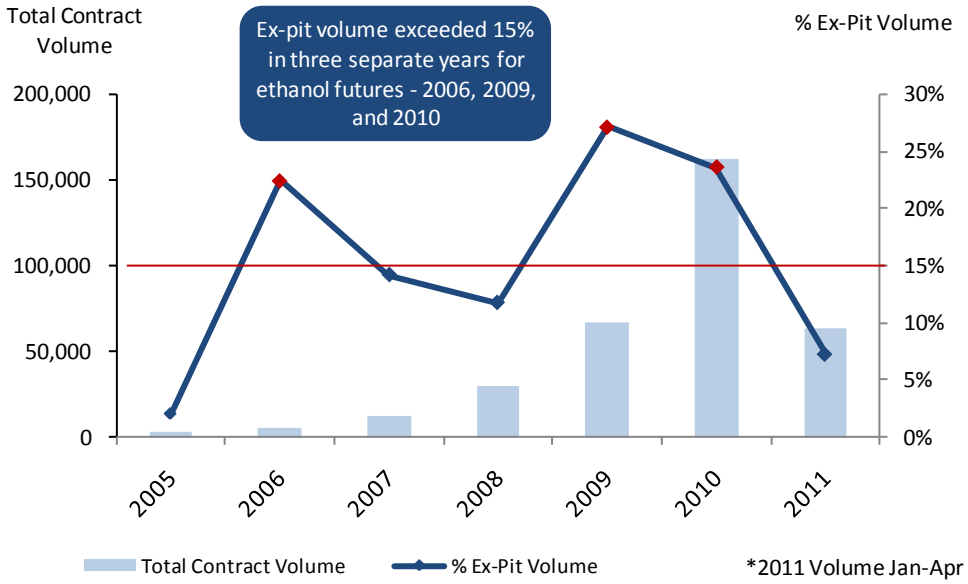


Table 3: CBOT Ethanol Futures – Total Volume and % of Ex-Pit Volume



With a prescriptive rule requiring a futures product to be delisted if it fails the centralized market trading requirement threshold, customers likely will not establish new futures positions in nascent contracts. Doing so would subject them to the risk that, within 12 months, the product they were utilizing to hedge their position would no longer be available as a futures contract on a DCM. Customers prefer trade certainty and will therefore seek to trade the same product on a SEF or in the uncleared OTC market. Consequently, the proposed rule will significantly erode the potential for future innovation in futures markets, discouraging exchanges from listing anything but the most promising contracts while simultaneously discouraging customers from participating in building liquidity in any new products.

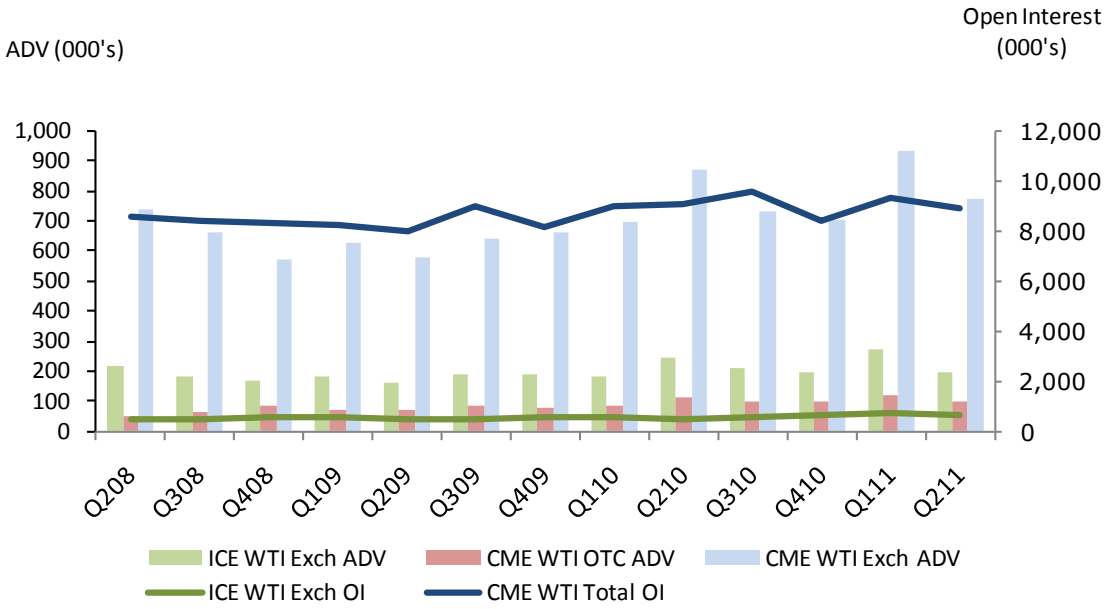
2. **The CFTC's 85% Rule will incentivize U.S. exchanges to list new products outside the U.S.** As illustrated above, new products are aided in developing liquidity in the centralized market by transactions executed outside the centralized market and the 85% Rule would arbitrarily and prematurely prevent many products from achieving traction and succeeding as futures products. With the risk of failing to meet the 85% Rule looming for both U.S. futures exchanges and their market participants, foreign regulatory regimes become an attractive alternative for listing new products or trading contracts offered by foreign exchanges that are not subject to this arbitrary rule, including cash-settled contracts that price off of and settle to the final settlement price of physically-delivered contracts trading on a U.S. exchange.

   An example of this can be seen in energy markets, where crude oil futures and swaps contracts are actively traded on both the CFTC-regulated NYMEX exchange and the foreign-regulated ICE exchange. The predominant price discovery contract for crude oil, WTI, is listed on NYMEX. NYMEX and ICE both list cash-settled futures contracts which are economically equivalent to NYMEX's WTI contract, as shown in Table 4 below. Based on current trading volume, NYMEX's cash-settled version of WTI would fail the Commission's proposed rule because more than 15% of the contract's volume is executed bilaterally, and submitted for clearing through CME ClearPort®. Failing this test would require NYMEX's cash-settled version of WTI to be delisted from the futures exchange and made available to trade as a swap on a SEF if NYMEX chose to continue to offer the product to the market. ICE's cash-settled version of WTI, however, would continue to be made available to trade as

a futures contract because it is listed for trading on a European exchange, which is not subject to such an arbitrary regulatory requirement.

Rather than run the risk of failing the Commission's arbitrary test, it is likely that CME Group would seek to list a cash-settled version of WTI on a foreign exchange affiliate to ensure that we are able to effectively compete by offering customers a comparable cash-settled contract. Indeed, as discussed below, listing NYMEX's cash-settled WTI contract on a SEF would make it uncompetitive with ICE's cash-settled alternative because, among other things, market participants would lose margin offsets between their physical and cash positions, overall margin requirements would more than double due to 5-day margining requirements and certain market participants would be forced to hold increased capital in order to continue trading the product.

Table 4: Crude Oil Market Participants Heavily Use Cash-settled Swap Contracts in Addition to Physically-delivered Futures Contracts



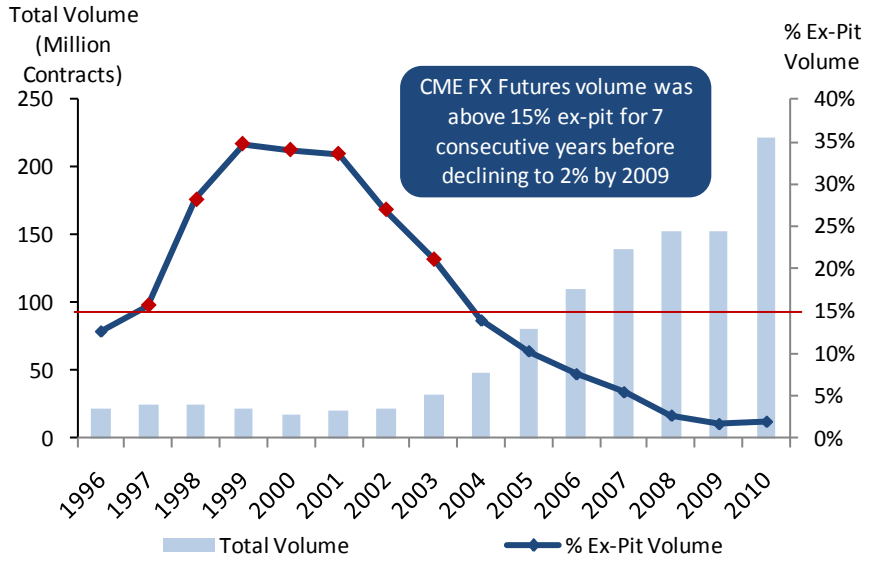
3. **The CFTC's 85% Rule will also force successful, mature and liquid futures contracts off of exchanges and onto SEF or OTC venues.** The CFTC's arbitrary test would cause many existing, liquid and successful contracts to be forced off of exchanges and onto SEF or OTC venues, preventing them from further developing into more liquid and transparent price discovery contracts. For example, in reviewing data for CME Group listed contracts, we determined that approximately 600 futures products will be reclassified as swaps; if we exclude energy and metals products from this number we have identified approximately 80 products that would fail. Within this group of products are several of our highly successful contracts which continue to serve legitimate customer needs.

The arbitrariness of the proposed 85% Rule is well illustrated by looking at the evolution of CME's highly successful foreign exchange futures market. CME's foreign exchange products were first introduced in 1972 and quickly matured into a successful open outcry market. In the early to mid-1990s, CME's foreign exchange market began to lose momentum as the interbank market became increasingly electronic. In the late 1990s, CME's open outcry volumes had declined and market users began to use EFP transactions in CME FX markets because they did not have access to prices in the interbank market while trading in the pit at CME. As indicated in Table 5 below, between 1997 and 2003, CME FX products – which were then 25 years old, would have failed the CFTC's test, resulting in their delisting and transfer to a SEF or the OTC market had the rule been operative at that

time. From 1999 to 2001, these products collectively traded above 30% ex-pit; and only moved within the 85% Requirement at 14% ex-pit in 2004; 10% in 2005; 8% in 2006; 6% in 2007; 3% in 2008; and 2% in 2009 and 2010. On an individual product basis, CME's Pound Sterling futures contract traded non-competitively above the 15% threshold from 1995 through 2004, and the highly liquid Euro futures contract traded more than 15% non-competitively from 1999 to 2003. In 2010 the Sterling and Euro only 1.6% and 0.9% of volume was executed non-competitively, respectively.

It is doubtful, if the rule had been operative during the early stages of these products' life-cycle that they would have subsequently developed in a fashion where an increasingly large percentage of total transactions were executed openly and competitively rather than through transactions outside the centralized market. Moreover, there is no evidence that price discovery in the central market suffered in any way during the time that central trading fell below 85%. Nevertheless, the CFTC proposals would count as an ex-pit trade that harmed price discovery, a block trade for 100 contracts where the futures commission merchant ("FCM") entered into the trade as a service to its customer and then laid off all the market risk it assumed in a subsequent futures trade in the central market. This common scenario underscores the arbitrary nature of the 85% restriction.

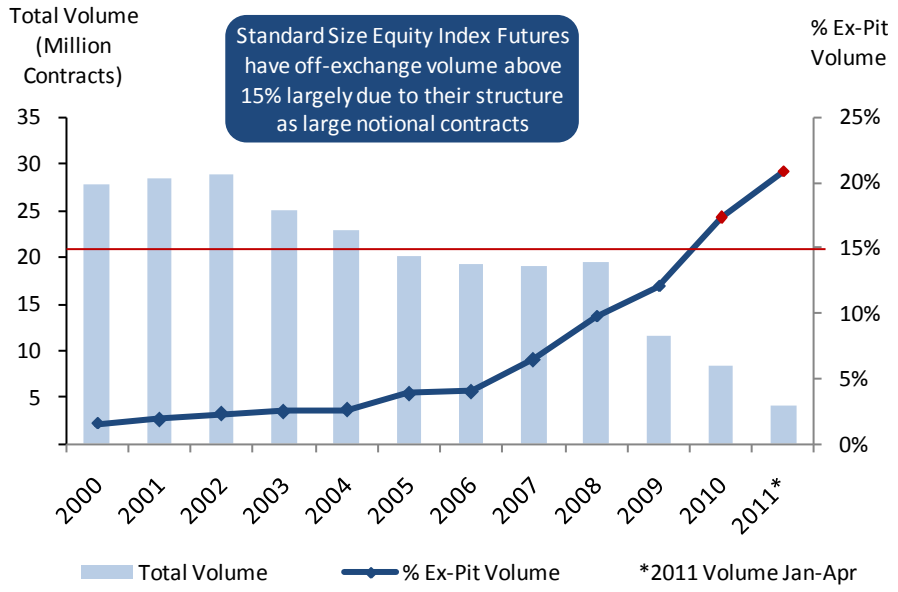
Table 5 CME FX Futures – Total Volume and % of Ex-Pit Volume



Other examples of products that would currently fail the Commission's test include our flagship standard size equity index futures contracts, including S&P 500®, NASDAQ 100®, S&P 400 Midcap®, $10 Dow®, and $25 Dow® futures. Unlike the CBOT 5-year swap futures or CBOT Ethanol futures, these products are very mature and have had robust volume and open interest for years, but would have failed the 85% test in recent years. These contracts have large notional contract sizes designed to appeal to particular customer segments, and, as shown in Table 6, privately negotiated transactions comprise more than 15% of the overall contract volume for these instruments. These standard size equity index futures are part of a broader suite of products, and as the eMini and eMicro futures contracts have gained traction, the standard size contracts continue to serve as a risk management tool for certain customer segments. To better frame the impact of such a rule, CME's standard size S&P 500 contract was, in 2010, the 11th largest equity index futures contract in the world by dollar value of volume traded. In the same year the volume of trading that occurred outside the centralized market accounted for 14.8% of trades in the standard S&P 500

contract. Simply put, the Commission's proposed rule would place the contract, 11th largest in the world, on the brink of delisting. Once again, this is a nonsensical result considering the liquidity and price discovery provided by the associated eMini futures contracts.

Table 6: CME Standard Size Equity Futures – S&P 500, S&P Midcap 400, Nasdaq 100, Dow Jones Industrial Average – Total Volume and % of Ex-Pit Volume



4. **The CFTC's 85% Rule will increase margin requirements by over 200%.** If a product is reclassified as a swap and is required to be traded on a SEF or OTC, under the CFTC's proposals market participants would be required to post more than twice the initial margin than if that same contract were permitted to be traded as a futures contract on a DCM. Specifically, another rule proposed by the CFTC would require a derivatives clearing organization ("DCO") to margin swaps submitted to it for clearing from a SEF or OTC based on losses that might be reasonably incurred over five business days, whereas the DCO would be permitted to margin a contract with identical terms and conditions submitted to it for clearing from a DCM based on losses that might be reasonably incurred over one day. The impact of the interaction of these two rules is remarkable. For example, based on the first six-months of trading in CME Group's standard S&P 500 futures contract, the contract would fail the 85% test by 1.79%. As a result of failing the test, this futures contract would be reclassified as a swap and be required to trade on a SEF or in the OTC market, increasing margin requirements by approximately 224% from $13.8 billion to $30.8 billion. Moreover, based on a recent analysis performed by CME Group, this change in margining would increase the overall collateral requirements for affected contracts by approximately 135%.[4] More specifically, based on a recent review of all CME Group products that would today fail the 85% test and be forced to be reclassified as a swap and traded on a SEF or OTC, market participants would lose approximately $7.6 billion in margin offsets, and overall initial margin payments would more than double from approximately $40 billion to $86 billion, increasing the cost of transacting by over $54 billion. Given the soundness of futures markets and central counterparty clearing historically, and more importantly, during the 2008 financial crisis, this adds unnecessary layers of cost to market participants.

[4] The overall increase in margin requirements for this collective group of products is approximately 135% rather than 224% because our clearing house currently margins many of these products for greater than 1-day liquidation.

Referring again to the various contracts supporting price discovery in natural gas, as depicted in Table 1, the 85% Rule would result in the following anomaly. NYMEX's cash-settled NN contract would fail to meet the test and be reclassified as a swap contract on a SEF – notwithstanding the fact that it is economically equivalent to and priced off of NYMEX's highly liquid, physically-delivered NG contract. As such, it would be subject to 5-day margining. In contrast, ICE's cash-settled LD1 contract, which is also economically equivalent to and prices off of NYMEX's NG contract would be eligible to trade on a DCM and receive 1 day margining. Given more than double margin requirements on the reclassified NN contracts, it is likely that customers will simply stop trading NN and migrate instead to ICE's LD1 contract. This example underscores the arbitrariness of the proposed 85% rule and the absence of any public benefit. It also again highlights the error in evaluating each instrument on a stand-alone basis where a given contract, which functions as a second-order derivative, accurately reflects the real-time, daily and final settlement price of a price discovery contract that meets the 85% test (e.g., NYMEX's NG contract).

5. **The CFTC's 85% Rule will create market risk and adverse tax and regulatory consequences for market participants holding "reclassified contracts."** The proposed 85% Rule requires that if a contract fails this centralized market trading threshold, market participants can either (i) trade for liquidation only or (ii) convert their futures open interest to swaps open interest. Both options have adverse consequences for market participants holding open interest in contracts that fail this arbitrary test.

   Market participants that must trade for liquidation only will face increased market risk as a result of this rule. Specifically, liquidity in the relevant market will be drained as a result of both other market participants' converting their open interest to swaps open interest and the absence of new participation in the market. In other words, it will be much more costly for those that trade for liquidation to ultimately get out of their positions because reduced liquidity likely will increase the bid-ask spread.

   Market participants choosing to convert their futures open interest into swaps open interest likely will experience adverse tax consequences. Specifically, futures contracts receive 60/40 tax treatment under the tax code. Swaps traded on a SEF or OTC do not. Many market participants value strongly the 60/40 tax treatment they receive trading futures products. For those that do, being forced to trade swaps on a SEF would result in an overall increase in the cost of doing business. For example, for an individual trader in the highest tax bracket, the trader would potentially net only $.65 on $1 of gain after federal income taxes at today's rates on a swap trading on an SEF. An economically equivalent future trading on a DCM would be marked to market for tax purposes and would net $.77 on the same $1 of gain. For an equivalent transaction, market participants lose 15% of their after-tax gains because they have been forced trade swaps instead of futures.

   Moreover, many market participants likely will qualify as "swap dealers" ("SDs") or "major swap participants" ("MSPs"). Qualifying as such comes with significantly enhanced regulatory requirements, resulting in what likely will be a substantial increase in the cost of doing business. Specifically, the CFTC is proposing capital requirements of $20 million plus additional amounts to cover (i) counterparty credit risk and (ii) additional market risk exposure.[5] Registration and detailed compliance obligations also would be imposed.

[5] This term refers to the additional amount of capital that must be maintained for the total potential market risk associated with such swaps and any product used to hedge such swaps, including futures, options, other swaps or security-based swaps, debt or equity securities, foreign currency, physical commodities, and other derivatives. The CFTC is proposing to include swap transactions and related hedge positions that are part of the SD's swap activities in the OTC derivatives credit risk requirement and market risk exposure requirement, and not swap positions or related hedges that are part of the SD's commercial operations.

6. **The CFTC's 85% Rule will limit the development of open and competitive price discovery markets by limiting access to "reclassified contracts" only to ECPs.** In order to trade swaps on a SEF or OTC, one must qualify as an ECP. ECPs include, among others, persons that are acting for their own account and are either: (a) a financial institution; (b) a commodity pool with total assets of $5M, (c) an entity with assets exceeding $10 million or having a net worth of $1 million and entering into the contract for purposes of managing the entity's risk; (d) an ERISA plan that has total assets exceeding $5 million, (e) a futures commission merchant, (f) a floor broker or trader, or (g) an individual with amounts invested on a discretionary basis, the aggregate of which is in excess of $10M or $5M and entering into the contract for purposes of his or her own risk management.[6]

   Limiting access to those market participants that do not qualify as ECPs is detrimental both to contracts forced off exchange as well as to market health, whereby liquidity and factors contributing to market depth and quality are lost with participants unable to transact. Moreover, it seems unfair and illogical to deny market participants that do not qualify as ECPs the ability to utilize the same risk management tools for their legitimate business purposes available to, generally speaking, wealthier market participants. In fact, this rule has the potential to lock non-ECPs out of price discovery markets altogether.

7. **The CFTC's 85% Rule would adversely impact the CME ClearPort® offering, increasing systemic risk and reducing liquidity in U.S. energy futures.** The CFTC's requirement that 85% of the volume of any futures contract listed for trading by a DCM trade via open outcry or on a CLOB would severely disrupt large portions of the market for illiquid energy futures contracts. The ability of producers and consumers to effectively hedge their energy risks will be significantly curtailed. The 85% limitation seems to be directed at shutting down the highly successful CME ClearPort® offering in energy rather than accomplishing a legitimate purpose of DFA.

   The notice of proposed rulemaking states: "The Commission believes that rather than seeking 4d orders for off-exchange products, certain DCMs have resorted to listing those products as futures despite their unlikely prospects for central marketplace trading, to achieve the same results as the Section 4d process to the possible detriment of the centralized market." (DCM Proposal at 90588, n. 95.) The Commission fails to explain the "detriment" to the centralized market nor does it offer any suggestion that any positive impact of its proposal is even remotely likely. The Commission's characterization of NYMEX's "ClearPort®" offering in the energy space ignores the significant risk mitigation value that this offering brings to the marketplace and market participants, including the contribution ClearPort makes to the price discovery process in the NYMEX suite of energy products.

   ClearPort® is a clearing technology that provides, among other things, capabilities for transactions executed in the first instance outside our centralized market to be cleared. NYMEX first offered this service to the OTC energy market in 2002 in response to demands for the elimination of trading counterparty credit risk in the wake of Enron's bankruptcy and the ultimate implosion of the energy merchant sector due to counterparty risk/credit concerns. At that time, Enron was counterparty to a significant volume of trades in the OTC energy space through its "Enron On-line" marketplace. This ClearPort offering reduces systemic risk by making a regulated clearing house the counterparty to every trade submitted for clearing. This innovative offering utilizes a transaction expressly permitted by the CEA – the exchange of futures for swaps ("EFS") – to bring OTC transactions into the clearing house so that customers ultimately hold a cleared futures position that, among other things, provides the customer greater protection in the event of a FCM bankruptcy and makes it easier in many markets for the customer to liquidate his or her position. Despite agreeing to permit the EFS transaction and allowing it to flourish in the energy markets for years, the Commission of late has taken the position that such transactions do not serve a legitimate business purpose because they harm price discovery. We, and many market participants, strongly disagree for the obvious reason

[6] A full list of entities and persons that qualify as ECPs can be found at Section 1a(18) of the Commodity Exchange Act. This term is subject to further definition by the CFTC through the rulemaking process.

that most of the contracts cleared are not yet sufficiently liquid to be supported on a double sided auction CLOB. In consequence, the Commission's proposed 85% Rule would force many of our energy contracts off our exchange and onto a SEF or into the OTC market; another proposed rule would ban the EFS transactions employed by so many energy market participants.

Once again, the CFTC presumes that any EFS transaction, block trade or directed RFQ detracts from price discovery on the central market. This is inaccurate; the CFTC is taking a snap shot approach to price discovery rather than making an accurate and realistic appraisal of the entire process. Let's consider the example of a typical ClearPort trade – one party wants to manage a price risk, the other party is willing to assume it. If the product is as unique as are most ClearPort products, there is no likelihood that a party will find a useful quote waiting for him on the CLOB. Market makers are typically not equipped to expose themselves to the sharply discontinuous and imbalanced batching of orders that characterize illiquid markets of quoting illiquid products would essentially constitute a business of waiting to get picked off.

Under DFA, Clearport will employ a block trading process, which will bring information on all block trades to the market quickly. In addition to the publication of the block price, many market makers in the less liquid ClearPort products will off-set the risk by using standardized futures contracts traded on the CLOB. It would be typical for a dealer to enter into a ClearPort trade in Jet Fuel – with current open-interest of 50 million barrels – and hedge that risk immediately with a heating oil futures position on GLOBEX or another of the products in the NYMEX energy suite. In that instance, the ClearPort trade directly results in more price discovery on GLOBEX, not less, as the CFTC has apparently presumed.

ClearPort trades also promote other public interests. In their dissent to the 85% Rule and the proposed rule to ban the EFS transactions employed in the NYMEX energy space which make the execution of the transaction contingent upon being accepted for clearing, Commissioners Sommers and O'Malia noted that for the past decade, ClearPort transactions have provided significant regulatory and public benefit, particularly in the energy space:

> Over the past decade, a long list of non-standardized, illiquid contracts in the energy sphere have been executed off-exchange and cleared on-exchange through the exchange of futures for swaps (EFS) mechanism. The availability of clearing for these contracts added a level of safety, soundness and transparency to the marketplace that did not exist before. If the Commission had not permitted these contracts to be listed for clearing through the EFS process it is highly doubtful that the level of clearing that exists today for these contracts would have been achieved, and highly likely that this activity would have remained opaque to market participants and regulators. (75 FR 80636.)

The 85% rule would have the ultimate effect of moving at least 490 of our listed energy products off the NYMEX DCM and onto a SEF or into the OTC market. The open interest for these products is approximately 36.6 million contracts. The overall transaction volume for these products for the first 6 months of 2011 was approximately 65 million; trading outside the centralized market accounted for 77% of that volume. This entire market would be forced outside the auspices of NYMEX as a result of the 85% Rule. Significantly, we believe that at least 350 contracts within this group likely would not be subject to the trading and clearing mandate, which means these markets would be pushed into the OTC space. No regulatory or public benefit would be achieved by this result.

As stated in our comment letter in response to the Commission's rule proposal, to the extent that there is an unstated philosophical issue with the continued use of the EFS transactions currently employed in bringing OTC energy trades into the clearing house, we may allow market participants to achieve the same result by adopting block trading rules which will have the added benefit of providing post trade price reporting. Specifically, subsection (b)(iii) of Core Principle 9 states that the rules of DCMs may permit "a futures commission merchant, acting as principal or agent, to enter into or

confirm the execution of a contract for the purchase or sale of a commodity for future delivery if that contract is reported, recorded, or cleared in accordance with the rules of the contract market or [DCO]." Subsection (b)(iii) grants DCMs discretion in setting block thresholds so long as such thresholds do not undermine any price discovery that may be occurring in the centralized market. The validity of such ex-pit transactions is underscored by CEA § 4(a), which expressly prohibits any person to execute or even offer to enter into a futures contract unless such transaction is "conducted on or subject to the rules of a board of trade which has been designated or registered by the Commission as a contract market." 7 U.S.C. § 4(a) (emphasis added). Congress certainly was aware of this language in Section 4(a) of the CEA when it passed DFA and chose not to eliminate it from the Act. Thus, there is no basis for the Commission to do so through the rulemaking process.

V. Conclusion

In enacting DFA, Congress intended to bring a significant portion of transactions in the OTC market into regulated clearing houses and onto SEFs or DCMs. In modeling the new swaps regulatory regime on the existing futures regulatory framework, Congress believed that if we experienced substantial market turmoil again, the swaps market would demonstrate the strength and stability evidenced by the futures markets during the 2008 financial crisis. It certainly defies logic to conclude that Congress intended for the CFTC, through the rulemaking process, to remove markets and market participants from the regulated futures markets and force them into trading reclassified swaps on SEF or OTC venues.

As highlighted in the discussion above, the CFTC's proposed rule requiring more than 85% of a contract's volume to trade in the centralized market in order to be able to be listed for trading on a DCM is clearly harmful to the market and should be abandoned. With no regulatory or public benefit resulting from this proposed rule, the Commission is not justified in imposing such substantial costs on market participants, competitively disadvantaging DCMs and potentially increasing systemic risk to the financial system.

As the Commission knows, every market is different and the value of the core principles regime is that it allows registered entities the flexibility to tailor rules to fit the characteristics of the various markets it hosts. A one-size-fits-all regulatory approach – whether in assessing whether a DCM complies with Core Principle 9 or whether a "swap" product is appropriately margined – is bad regulatory policy and bad for markets. CFTC rules or guidance in this area should focus on whether a DCM evidences good faith efforts to support competitively traded markets, where appropriate. Such an approach is consistent with the principles-based regulatory policy that Congress preserved for DCMs and extended to other registered entities through DFA.