COUNCIL ON FOREIGN RELATIONS

58 EAST 68TH STREET • NEW YORK • NEW YORK 10021
Tel 212 434 9622 *Fax* 212 434 9875 *Email bsteil@cfr.org*
www.cfr.org

Benn Steil
Director of International Economics

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Ms. Eileen Donovan
Acting Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, DC 20581

Dear Ms. Donovan,

I am writing to summarize my views, expressed at your public hearing on June 27, as to how the Commission should assure proper regulation of Foreign Boards of Trade (FBOTs) providing trading access in the U.S., pursuant to a Commission no-action letter, if and when such FBOTs achieve a significant US presence.

The Commission asks specifically whether volume on an FBOT originating in the U.S. is an appropriate criterion for determining whether an FBOT is no longer “located outside the U.S.,” and might thereby be required to obtain registration from the Commission as a designated contract market (DCM) or derivatives transaction execution facility (DTEF). Such a requirement would generally imply significant costs to the FBOT, not least those deriving from the creation of overlapping and conflicting regulatory jurisdictions.

In addressing this question, the Commission needs first to consider what public interest is served in repealing a no-action letter on the basis of some specific measure of U.S. volume. When no-action letters are premised on U.S. access to the FBOT being limited to professional investors, investor protection concerns should not be the driving criterion. Further, the fact that contracts traded may be related to products “integral to the U.S. economy” is not a compelling basis upon which to extend Commission jurisdiction. All manner of products critical to the U.S. economy – from currencies, to interest rate contracts, to vital commodities – have long been produced and traded in great quantities outside American borders. And given the enormous economies of scale and network externalities in the exchange business, it is inevitable that global trading in key derivatives contracts will be concentrated on a handful of very large exchanges, some of which will be domiciled abroad. Where there is no demonstrable basis on which to believe that asserting Commission jurisdiction will make the U.S. economy any less vulnerable to outside influences, the potential costs to the U.S. economy of the Commission triggering a wave of retaliatory jurisdiction assertions by foreign regulators should give it pause.

There is, however, one important reason why U.S. volume should motivate heightened Commission interest in the activities of an FBOT. One can envision a situation in which U.S. participation in trading a specific contract on a foreign exchange were sufficiently large – in terms of the number of U.S. institutions participating, the size of such institutions, and the volumes traded – such that a problem in the exchange's clearinghouse could trigger a wave of defaults which could spread throughout the U.S. financial markets, even among institutions which were not participants in the foreign market. Clearinghouses bring enormous cost reduction and risk reduction benefits to derivatives markets participants, but they in turn concentrate risk in a single institution in such a way that failure of this institution could be a source of systemic risk in the U.S., given a sufficient degree of U.S. participation. As the major world derivatives exchanges inevitably grow larger, their clearinghouses become correspondingly more systemically important institutions.

It should be emphasized that there are numerous ways in which the Commission could assure itself of the soundness of the financial condition and risk management practices of a foreign clearinghouse short of repealing a no-action letter for its FBOT. The Commission might, for example, require further information from the FBOT's foreign regulator, and perhaps even demand a change in clearinghouse practice, such as margin requirements, as a condition for continuing a no-action letter. In essence, "no-action" is a misnomer for this regime: the Commission should be active, and has indeed been active, in assuring that an FBOT providing U.S. access is properly regulated. However, repealing a no-action letter would be the appropriate action for the Commission to take were it unable to assure itself that significant U.S. participation in trading an FBOT's contract did not represent a source of systemic risk for the U.S. financial markets generally.

It is imperative to recognize what an enormous success the no-action regime has been since its inception in 1996. The U.S. activities of one beneficiary alone, Eurex (formerly DTB), have had a tremendous effect in accelerating the move to more efficient electronic trading, in motivating exchanges to demutualize and thereby enfranchise non-brokers in the running of exchanges, in reducing trading fees, and in stimulating new product development in both the U.S. and Europe. Few remember now that it was the advent of electronic trading in 10-year German bundt futures from Chicago that shifted volume in the contract from then-floor-based LIFFE to Eurex, and thereby triggered a wave of global market reforms which has benefited U.S. derivatives users enormously. The rise of cross-border exchange competition has itself been critical to protecting U.S. investor interests.

In contrast, Eurex's parent exchange, Deutsche Börse, has never been able to secure comparable cooperation from the Securities and Exchange Commission to provide U.S. access for equities and other products under its jurisdiction, with the result, I would argue, that the New York Stock Exchange has been far slower in adopting necessary market structure, governance and regulatory reforms than it otherwise would have been. The CFTC is therefore to be heartily congratulated for its far-sighted foreign market access policy over the past decade, which has produced a renaissance in U.S. exchange traded derivatives with no accompanying regulatory failures.

In conclusion, I would urge the Commission to avoid applying any mechanistic trigger based on U.S. volume in an FBOT contract which would result in repeal of a no-action letter. Measures of U.S. participation should be used by the Commission to gauge whether systemic risk to the U.S. financial markets could result from a failure at the FBOT's clearinghouse, although such legitimate concern is most effectively addressed initially by the Commission requiring greater cooperation from the FBOT or its regulator, and perhaps enhancements to the risk management practices at the FBOT's clearinghouse. Repeal of a no-action letter should be a last resort, as a breakdown of cooperation among global derivatives regulators can only result in the emergence of costly and dangerous competition for jurisdiction among national authorities.

I thank the Commission for the opportunity to share my views at the June 27 public hearing, and I stand ready to provide any further assistance which it might find useful.

Yours sincerely,

Benn Steil