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October 20, 2003

## By Federal Express

Jean A. Webb, Secretary  
Office of the Secretariat  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, N.W.  
Washington, DC 20581

Re: Response to Comments of Chicago Mercantile Exchange and the Board of Trade of the City of Chicago on HedgeStreet, Inc.'s Application for Designation as a Contract Market and Registration as a Derivatives Clearing Organization

Dear Secretary Webb:

HedgeStreet, Inc. ("HedgeStreet") submits this response to the comments of the Chicago Mercantile Exchange ("CME") and the Board of Trade of the City of Chicago ("CBOT") (collectively, the "Chicago Exchanges") on HedgeStreet's Application for Designation as a Contract Market and Registration as a Derivatives Clearing Organization (the "Application"). As shown below, those comments are without merit and raise no issues not already addressed in HedgeStreet's Application and the many exchanges between HedgeStreet and the Commission staff. Therefore, those comments should not prevent approval of HedgeStreet's Application. Moreover, because the Application satisfies the plain language of the Commodity Exchange Act (the "Act") and the Commission's regulations, and because the Congressional mandate of the Commodity Futures Modernization Act of 2000 ("CFMA") is for the Commission to encourage competition and innovation, HedgeStreet's Application should be approved.

## I. BACKGROUND

HedgeStreet first initiated the process of applying for designation as a contract market on an informal basis in the spring of 1999, when representatives of HedgeStreet met with a number of representatives of the Commission staff. The purpose of meeting with the staff at a

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very early stage was to obtain an assessment from the staff of the likelihood of approval for the basic concepts of the HedgeStreet exchange and to obtain the staff's guidance in the application process to avoid wasted effort.

HedgeStreet has in the four years since worked closely with the Commission and its staff, including submitting numerous draft and proposed final applications, providing detailed responses to many rounds of questions and comments, and attending several meetings with the staff and members of the Commission in person in Washington. During those four to five years, the Commission revised its regulations governing contract market designation, withdrew those regulations, and again issued new regulations following the adoption of the CFMA. Each time the regulatory landscape changed, HedgeStreet changed its draft application or submitted supplemental documentation demonstrating that its proposed market was in conformity with the changed requirements.

Soon after submission of HedgeStreet's penultimate application, on April 30, 2002, HedgeStreet was informed by the staff that HedgeStreet had satisfied all of the staff's comments and that a recommendation for conditional approval was being sent to the Commission. For policy reasons, the Commission chose not to issue a conditional approval of HedgeStreet's penultimate application, but rather to wait until HedgeStreet was at a stage of development when final approval could be issued. At HedgeStreet's request, the Commission issued a letter (the "Conditions Letter"), dated August 1, 2002, setting forth the "additional steps [that] must be taken in order to issue a final contract market designation to HedgeStreet." As set forth in my letter of September 22, 2003, to you, as well as in the Application, HedgeStreet has satisfied each of the requirements of the Conditions Letter.

Thus, HedgeStreet has satisfied the statutory requirements of the Act as amended by the CFMA, the regulatory requirements of the Commission's rules, and the requests of the staff and the Commission. Nonetheless, the Chicago Exchanges now ask the Commission to disapprove HedgeStreet's Application and to impose additional requirements on HedgeStreet; requirements that are not found in the Act or the Commission's regulations. Because HedgeStreet has satisfied the applicable requirements, the Commission should reject this effort by the Chicago Exchanges to prevent HedgeStreet from offering its innovative hedging instruments to the public.

## **II. HEDGESTREET'S RESPONSES TO THE COMMENTS**

### **A. THE APPLICATION IS COMPLETE AND HAS BEEN SUFFICIENTLY EXPOSED TO PUBLIC COMMENT**

The Chicago Exchanges' first argument for denial of the Application is that only certain portions of the Application have been made public. (See October 14, 2003, letter from Craig S. Donohue to Jean Webb (the "CME Letter") at Section I; and October 13, 2003, letter from Bernard J. Dan to Jean A. Webb (the "CBOT Letter") at page 2.) In the first instance, there

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is no statutory or regulatory requirement that the entire Application be made public and thereby be made available to HedgeStreet's potential competitors. The Act and the Commission's Regulations require only that HedgeStreet submit an application to the Commission containing the relevant materials required by the Commission. *See* Sections 5(a), 5b(c), and 6 of the Act and Commission Regulations 38.3(a) and 39.3(a). Then, in order to obtain designation as a contract market, HedgeStreet is required to provide the public with access to HedgeStreet's "rules, regulations, and contract specifications." *See* Section 5(b)(7) of the Act and Appendix A to Part 38, Designation Criterion 7.<sup>1</sup> HedgeStreet has submitted all materials requested by the Commission, and HedgeStreet's rules, regulations, and contract specifications are posted on the Commission's website, satisfying the requirements of the Act and the Commission's regulations.

**B. HEDGESTREET'S OWNERSHIP AND MANAGEMENT HAVE BEEN DISCLOSED AND ARE FULLY QUALIFIED**

Pareto Partners Ltd. ("Pareto") and its principals are not qualified, in the eyes of the Chicago Exchanges, to have ownership of a designated contract market ("DCM") or registered derivatives clearing organization ("DCO"). Specifically, the Chicago Exchanges argue that HedgeStreet's owners and officers have not disclosed enough information about themselves, are not registered in any capacity with the Commission, and do not, in the view of the Chicago Exchanges, have sufficient futures experience. (*See* CME Letter at II.A. and CBOT Letter at I.) The argument is not well-founded in fact and is not supported by any statutory or regulatory provision. The Application establishes that HedgeStreet, its owners, officers, and advisors have substantial theoretical and practical financial markets expertise at their disposal. One of HedgeStreet's principals, John Nafeh, holds a doctoral degree in decision and risk analysis and has been actively involved in the application of those fields to business and financial settings for more than 20 years. Other owners of HedgeStreet have significant direct trading experience in the financial markets, as described at page 34 of the Application. HedgeStreet's service providers include a DCM and two DCOs, and, it is anticipated, National Futures Association ("NFA"). HedgeStreet's in-house staff includes operations personnel with decades of operations experience at major financial institutions and years of direct trading and supervisory experience in the futures markets, as well as compliance staff with years of experience in retail brokerage. HedgeStreet's outside law firm is counsel to many participants in the futures industry. HedgeStreet's board of advisors includes a former Chairman of the Commission and a Stanford professor who is a prominent figure in the field of risk analysis. Thus, although HedgeStreet is a start-up exchange, it has in-house or on retainer personnel and entities with very substantial relevant experience and expertise.

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<sup>1</sup> CME quotes Designation Criterion 7 in support of its assertion that HedgeStreet is required to release the entire Application, but Designation Criterion 7 is limited by its plain language to HedgeStreet's "rules, regulations, and contract specifications."

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C. HEDGESTREET'S MEMBERSHIP REQUIREMENTS ARE APPROPRIATE TO ITS MARKET

The Chicago Exchanges' third argument for denial of the Application is that HedgeStreet's membership requirements are inadequate. (*See* CME Letter at II.A. and CBOT Letter at 3.) HedgeStreet is required to "establish and enforce appropriate fitness" and "appropriate admission and continuing eligibility" standards for its members. *See* Sections 5(d)(14) and 5b(c)(2)(C) of the Act. "Appropriate" is the key word under these provisions, which were added as part of the CFMA's effort to increase competition through the encouragement of new DCM and DCO structures. As the Commission's Application Guidance makes clear, if a member of a contract market merely has trading privileges, minimal fitness standards apply. *See* Appendix B to Part 38, Core Principle 14, Application Guidance (a)(1). Members of HedgeStreet do not participate in the governance of HedgeStreet, do not act as intermediaries for other Members, and, most importantly, do not expose HedgeStreet to credit risk because contracts must be fully paid for in advance. Therefore, the fitness standards proposed by HedgeStreet are appropriate, as contemplated by the Act as amended by the CFMA, and by the Commission's regulations.

D. HEDGESTREET'S CLEARING AND SETTLEMENT SYSTEMS ARE ADEQUATELY DESCRIBED

The Chicago Exchanges' fourth argument for denial of the Application is that HedgeStreet's clearing and settlement systems are inadequately described. (*See* CME Letter at II.C. and CBOT Letter at 2.) As has already been noted in Part II.A. of this response, above, the only information that HedgeStreet is required to disclose to its competitors and the broader public in order to obtain designation as a contract market is HedgeStreet's rules, regulations, and contract specifications. In its Application HedgeStreet has disclosed to the Commission the system that HedgeStreet will use to trade, clear, and settle its contracts. The Commission is fully aware of all aspects of that system, because that system has already been approved by the Commission as a DCM and DCO and is currently in use to clear and settle contracts at Commission-designated contract markets. HedgeStreet has also disclosed to the Commission the identity of its settlement bank and the capacities in which that settlement bank will function. HedgeStreet would prefer at this time not to identify publicly its service providers. Nor is it required by statute or regulation to do so.

E. HEDGESTREET MAY ADJUST THE TERMS OF OUTSTANDING CONTRACTS TO ACHIEVE FAIRNESS

The Chicago Exchanges' fifth argument for denial of the Application is that HedgeStreet may adjust outstanding HedgeStreet contracts in the event of a material change in the underlying or in the event the expiration value for an underlying is unavailable or undefined. (*See* CME Letter at II.C. and CBOT Letter at 5.) Again, there is no statutory provision or regulation that suggests that this approach is inappropriate. HedgeStreet must have discretion to

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adjust its contracts when extraordinary circumstances or events would otherwise make outcomes undefined or indeterminate, and HedgeStreet believes the most appropriate manner to exercise that discretion is to achieve fairness to all holders of the affected series. HedgeStreet is not alone in this regard, as rules similar to those proposed by HedgeStreet have previously been approved by the Commission with respect to at least one other DCO. (*See* Article XII, Section 3(a) of the By-Laws of The Options Clearing Corporation.) Moreover, CME also has discretion in making adjustments. (*See* CME Rule 35103.A.) Even so, CME suggests that HedgeStreet should be required to “implement procedures to ensure that any adjustment allocation does not favor one Member (or group of Members) at the expense of another (or group of Members).” HedgeStreet’s contracts do just that, and, as would CME, HedgeStreet would suffer loss of confidence in its market and litigation risk if it abused its discretion in adjusting contracts. For the foregoing reasons, HedgeStreet believes this comment to be without merit.

F. HEDGESTREET’S ARRANGEMENTS WITH NFA

The Chicago Exchanges’ sixth argument for denial of the Application is that HedgeStreet does not have, and has not disclosed the terms of, its final agreement with NFA for NFA to provide trade practice and market surveillance services. (*See* CME Letter at II.B.1. and CBOT Letter at 5.) and footnote 1.) As discussed in Part II.A. of this response, above, HedgeStreet is not required by statute or regulation to disclose to competitors or the public at large any of the terms of its arrangement with NFA. The Chicago Exchanges are correct that HedgeStreet does not have a final agreement in place with NFA. However, HedgeStreet does have a letter of commitment in place with NFA, and HedgeStreet and NFA are in active negotiations to finalize an agreement that can be presented to NFA’s Board for approval. The staff of the Commission is aware of HedgeStreet’s efforts and previously advised HedgeStreet that HedgeStreet could submit the Application for consideration while finalizing its agreement with NFA. Moreover, HedgeStreet understands that one or more previous applicants for contract market designation have followed this same procedure. So long as HedgeStreet has in place, before it begins operations, an agreement for trade practice and market surveillance that is acceptable to the Commission, the statutory and regulatory requirements for designation will be met.

G. HEDGESTREET HAS ADEQUATELY DISCLOSED SURVEILLANCE PLANS

Closely related to the previous comment are the Chicago Exchanges’ arguments that the Application should be denied because HedgeStreet’s rules do not disclose who will perform its in-house regulatory functions, the type of data that will be analyzed, and what types of unusual activity will be surveilled. (*See* CME Letter at II.B.2. and CBOT Letter at 5.) Once again, there is no statutory or regulatory requirement that such information be disclosed in HedgeStreet’s rules. Moreover, neither the rules of CME nor the rules of CBOT contain such information, making their comments in this regard perplexing. Finally, HedgeStreet has

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disclosed in its Application the identity of its compliance officer and how its surveillance and compliance function will be carried out in conjunction with NFA.

#### H. POSITION LIMITS

The Chicago Exchanges argue that the Commission is required to deny the Application because HedgeStreet proposes no position limits. (*See* CME Letter at II.B.2. and CBOT Letter at 5.) The assertion that the statute or regulations require position limits is simply and obviously incorrect. Core Principle 5 only requires position limits “where necessary and appropriate.” *See* Section 5(d)(5) of the Act. HedgeStreet has maintained, and continues to maintain, that position limits on contracts with underlyings of the type it proposes to trade are not necessary or appropriate to reduce the threat of market manipulation. The Chicago Exchanges have not raised any persuasive arguments to the contrary. Indeed, references to potential manipulation of the consumer price index are far-fetched. Moreover, HedgeStreet will have agreements in place and in-house compliance operations for the monitoring of its market, and if HedgeStreet were in the future to determine that a contract required position limits in order to avoid manipulative activity, it would certify, or propose, to the Commission that HedgeStreet be permitted to adopt limits with respect to that contract.

#### I. HEDGESTREET’S RULES PROHIBIT MARKET MANIPULATION

The Chicago Exchanges complain that HedgeStreet’s rules do not expressly prohibit market manipulation. (*See* CME Letter at II.B.2. and CBOT Letter at 5.) In fact, market manipulation is prohibited by Sections 6(c) and 9(a)(2) of the Act and, therefore, no additional rules are needed to bar such activity. Because market manipulation is prohibited by the Act, and to protect the integrity of its market, HedgeStreet does not intend to allow, and will prohibit, manipulative activity. Such activity falls within the prohibitions detailed in HedgeStreet Rule 3.13, including the broad language at 3.13(b) and (h) (prohibiting trading that has an illegitimate purpose and any activity that adversely affects the integrity of HedgeStreet’s market). However, to the extent that the Commission believes HedgeStreet should include an express prohibition on market manipulation in Rule 3.13, HedgeStreet would do so.

#### J. HEDGESTREET HAS SUFFICIENTLY DISCLOSED THE TERMS OF ITS CONTRACTS

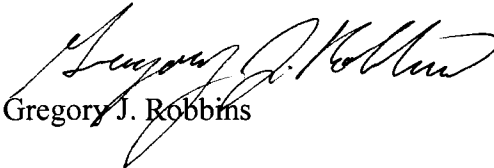
CBOT’s tenth argument for denial of the Application is that HedgeStreet has not disclosed the terms of the contracts it proposes to list. (*See* CBOT Letter at 4.) This argument is invalid. First, HedgeStreet’s rules do describe the material terms of its contracts, omitting only the underlyings. After the CFMA the Commission does not designate contract markets on a contract-by-contract basis, so the description in HedgeStreet’s rules which omits only the underlyings is sufficient. Second, Core Principal 7 is not a designation requirement, but rather a post-designation requirement. *See* Section 5(d)(7) of the Act. Thus, this argument should not prevent approval.

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### III. CONCLUSION

The comments of the Chicago Exchanges are a transparent attempt to stifle competition and are not a valid basis for the Commission to disapprove HedgeStreet's Application. HedgeStreet has, during the course of the last four years, provided the Commission and its staff with materials demonstrating that HedgeStreet satisfies all requirements of the Act and the Commission's regulations governing DCMs and DCOs, and responded to all additional requests from the Commission and its staff. The Commission's charge from Congress, embodied in the amendments to the Act contained in the CFMA, is to stimulate competition and encourage innovative new contracts and contract markets. HedgeStreet is such a contract market, and seeks to provide the public with access to simple and highly useful hedging opportunities never before offered. HedgeStreet urges the Commission to follow the mandate from Congress to encourage competition and approve the Application without further delay.

Kind regards,



Gregory J. Robbins