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VIA ELECTRONIC DELIVERY

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Concept Release Concerning Self-Regulation; File No. S7-40-04; 69 *Fed. Reg*. 235 (December 8, 2004)

Dear Mr. Katz:

The Chicago Mercantile Exchange Inc. ("CME") welcomes the opportunity to comment upon the Securities and Exchange Commission's ("SEC" or "Commission") concept release concerning securities industry self-regulatory organizations ("SROs")(the "Concept Release"). CME is currently the largest futures exchange in the United States and the largest derivatives clearing organization in the world. As an international marketplace, CME brings together buyers and sellers on its CME GLOBEX® electronic trading platform and trading floors. CME offers futures and options on futures primarily in four product areas: interest rates, stock indexes, foreign exchange and commodities. CME is also a self-regulatory organization responsible for ensuring market integrity and financial security for all transactions in its products. Our activities as an SRO are subject to the exclusive jurisdiction of the Commodity Futures Trading Commission ("CFTC").

CME is also the only demutualized and publicly-traded futures exchange in the United States. As such, CME is subject to the corporate governance standards and listing requirements imposed by the New York Stock Exchange. While the nature of the Commission's Concept Release does not apply directly to CME (*see* 69 *Fed. Reg.* 71256, fn 2), we believe that our experience and leadership in self-regulation as a demutualized futures exchange accountable to shareholders and the marketplace will be beneficial to the Commission in determining whether to adopt industry-wide best practices for securities and securities options exchanges.

I. THE MODEL OF SELF-REGULATION, IN WHICH A DEMUTUALIZED MARKET CENTER AND REGULATORY FUNCTION EXIST WITHIN THE SAME ENTITY, IS EFFECTIVE AND TIME-TESTED.

In the Concept Release, the Commission states that the current "SRO structure has been repeatedly reaffirmed both by Congress and the Commission . . . It is generally considered that the SRO system has functioned effectively and has served government, industry, and investors well." 69 *Fed. Reg.* 71257-58. We believe that a demutualized exchange that is accountable to shareholders and the marketplace should be able to have the ability to maintain its market center functions (*i.e.*, the operation and promotion of the marketplace) and regulatory (both market and member) functions within the same corporate entity. The industry and market participants are well served by such a demonstrably effective model.

A. <u>Incentive to Regulate and Brand Identity</u>

We believe that the current model of self-regulation works with respect to demutualized exchanges because of the business incentive to operate a fair, financially sound and competitive marketplace. Reputation and competition are powerful motivating forces for ensuring proper behavior, especially in today's global environment where market participants have virtually immediate, around-the-clock access to a broad range of competing markets and products.

Moreover, publicly-traded, for-profit markets have a unique incentive to properly discharge their statutory self-regulatory responsibilities. Such markets operate in a transparent environment in which research analysts and institutional shareholders scrutinize management's business decisions and monitor the company's stock performance. Any failure to maintain and effectively implement prudential regulatory programs could cause analysts and shareholders to adopt a negative view of performance and stock prices could be adversely impacted. Indeed, the results of any materially adverse agency action involving the market would require disclosure to shareholders.

Ultimately, CME believes that our market surveillance and financial supervision regulatory capabilities are part of the brand identity that we have created. In serving the marketplace, we stress the quality and strength of our regulatory capabilities as an attraction to our products, markets and services. Market participants use our markets, in part, because they know that we operate with high standards for market integrity and for supervision of trading activity, sales activity and financial activity on the part of our member intermediaries.

B. <u>Commission Oversight and Remedies for Non-Compliance</u>

The Securities Exchange Act of 1934 ("Exchange Act"), Securities Acts Amendments of 1975 and Commission regulations currently impose strict self-regulatory responsibilities on all SROs, which include the requirement that SROs enforce all of their rules and maintain continuing programs to ensure compliance with the Exchange Act, the Commission's regulations and the SRO's rules.

In the event that a SRO fails to satisfy these requirements, the Commission is empowered to compel the SRO to fulfill its responsibilities, and may even suspend or revoke the SRO's designation.[1] As discussed in the Concept Release, the Commission has, where appropriate, taken such measures to enforce compliance. *See* 69 *Fed. Reg.* 71258. We believe that these remedies are adequate to properly supervise and enforce self-regulatory responsibilities.

C. <u>Funding the Self-Regulatory Function</u>

Any notion that an established for-profit entity might attempt to attract order flow or increase its profits through lax self-regulation is misplaced. Exchanges have a strong incentive to adequately fund and ensure the integrity of their markets. CME, for example, has maintained the significant resources that it devotes to self-regulation since going public. In this respect, we note that Professor Craig Pirrong of the University of Houston has found that a for-profit SRO, as opposed to a not-for-profit SRO, would generally <u>not</u> have an incentive to attract volume or increase its profits through lax self-regulation.[2] According to Professor Pirrong, the not-for-profit form is an example of "what economists call a 'low power incentive system.' Economists have demonstrated that low power incentives can serve as a customer

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[1] *See* Section 19 of the Exchange Act.

[2] *See* Craig Pirrong, A Theory of Financial Exchange Organization, 43 J. of Law & Econ. (2000); Craig Pirrong, Electronic Exchanges are Inevitable and Beneficial, 22 Regulation (1999).

protection device when the 'quality' of a firm's output is not observable (either by customers, or by third parties charged with enforcing contracts between the firm and its customers). However, most of the attributes of exchange self-regulatory efforts have observable and often quantifiable impacts, especially for institutional traders." The for-profit form thus creates a strong incentive to regulate intensely, while the not-for-profit form "is likely to have little impact on the intensity of exchange self-regulatory efforts."[3]

Operating as a for-profit company thus impels CME to further strengthen its brand through effective self-regulation.

D. Combined Knowledge of Market and Regulation

Many exchanges, such as CME, have built extensive and sophisticated regulatory systems and programs to ensure market integrity and financial safeguards for market users. Such exchanges have assembled some of the most talented regulatory, risk management and financial supervision experts in the world of trading. At CME, these people consist of employees in our market regulation department, financial audit area, risk management and clearing house departments, legal department and trading floor personnel. The quality of our overall regulatory system depends heavily on the integration of these separate functions and on the manner in which these staff are able to coordinate closely their activities and information sharing. Unbundling any part of this extensive and intertwined system will likely damage the protections afforded to the industry and market participants.

Moreover, in times of a market crisis, these staff members work together as a tightly knit team that is responsive to CME's needs to ensure market integrity and financial safeguards. Emergency situations demand the highest level of coordination, and significant disadvantages can accrue from having to coordinate emergency activities across separate organizations.

Finally, many of the trade practice and other irregularities that we investigate and prosecute come from referrals from members, clearing members and customers. We have developed a "public trust" that ensures a high degree of comfort for persons making such referrals. Moving any of our self-regulatory functions could impair this network of effective regulatory referrals.

E. Time-Tested and Internationally Accepted

The current model is not only time-tested, but internationally accepted. As a publicly-traded exchange, CME is not alone in effectively combining its market center and self-regulatory functions. Internationally, for example, demutualized exchanges such as Euronext, N.V. (through its various markets), the Singapore Exchange (SGX), OMX (through its Stockholmsborsen market), and the London Stock Exchange (LSE), all employ a model that generally combines the market center function with the self-regulatory function. Such a model is thus not only well accepted internationally, but demonstrates that the model effectively permits demutualized exchanges to satisfy their self-regulatory obligations.

CME thus believes that the best—and most time-tested—model of self-regulation is the model that permits demutualized exchanges to regulate their markets.

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[3] Letter of Craig Pirrong, Professor of Finance and Director of the Global Energy Management Institute, Bauer College of Business of the University of Houston, to Jean A Webb, Secretary, Commodity Futures Trading Commission (Sep. 13, 2004).

II. EXCEPT FOR ASPECTS OF THE COMMISSION'S SRO GOVERNANCE AND TRANSPARENCY RULEMAKING, THE ALTERNATIVE MODELS MENTIONED BY THE COMMISSION WOULD NOT REPRESENT AN IMPROVEMENT, ARE NOT COST-EFFECTIVE AND ARE UNTESTED.

In the Concept Release, the Commission raises the prospect of adopting an alternative model of self-regulation. The alternative models are implementing: 1) proposed enhancements to the current SRO system, as set forth in the Commission's SRO Governance and Transparency Rulemaking; 2) a model involving independent regulatory and market corporate subsidiaries; 3) a hybrid model; 4) a competing hybrid model; 5) a Universal Industry Self-Regulator; 6) a Universal Non-Industry Regulator; and 7) a model of direct Commission regulation of the industry.

Except with respect to improving the current SRO system through incremental enhancements through the Commission's SRO Governance and Transparency Rulemaking, each of the alternative models are subject to significant flaws, which are briefly summarized below.

A. <u>SRO Governance and Transparency Rulemaking Proposal</u>

In the Concept Release, the Commission recognizes that, "[g]iven that the current SRO system has provided essential regulation of markets and members for over seven decades, the SEC suggests that one approach would be to merely improve the identified limitations of self-regulation." 69 *Fed. Reg.* 71276. In this respect, on December 8, 2004, the Commission released its SRO Governance and Transparency Rulemaking.

CME believes that the incrementalized approach set forth by the Commission in its SRO Governance and Transparency Rulemaking proposal generally represents the right step to improving, rather than rewriting, the self-regulatory system. Such an approach recognizes the efficacy, effectiveness and efficiency of the current system, while attempting to enhance the system through incremental improvements. CME has submitted a detailed comment letter in response to the Commission's SRO Governance and Transparency Rulemaking. The letter is available on the Commission's website.

B. <u>Independent Regulatory and Market Operation Subsidiaries</u>

Under this model, the Commission would mandate that all SROs create independent subsidiaries for their market center and regulatory operations. The regulatory staff of each SRO would be placed within an independent regulatory subsidiary, which would report directly to the corporate parent's board.

We do not believe that the independent subsidiaries model would represent an improvement over the current system. The model is defective because:

- <u>Perceived Conflicts Would Continue to Persist.</u> The independent regulatory subsidiary would remain part of the larger competitive enterprise. While the internal segregation of the regulatory and market roles of the SRO might reduce perceived conflicts of interest in the securities arena to a certain extent, such conflicts—to the extent that they exist—are likely to persist. Notably, the two functions remain in the same entity and the entity as a whole has an interest in promoting its own interests. The model would thus not materially improve upon any perceived conflicts of interest concerns.

- <u>Self-Regulation Funding Concerns.</u> In the context of regulatory funding, the model does not address any perceived potential influence of members, shareholders and increased competitive pressures that could have an adverse impact upon the regulatory budgeting process. To the extent that such influences exist, the model would not improve upon them.

- Reduction in Market Knowledge. The model would reduce market specific knowledge on the part of the regulatory staff by removing the staff on a corporate level from market operations. Such a forced division of expertise would hamper, rather than help, regulatory personnel in attempting to regulate the market, and remove any opportunity for synergistic benefits.

C. The Hybrid Model

Under the Hybrid model, the Commission would designate a market-neutral single SRO (the "Single Member SRO") to regulate all SRO members with respect to membership rules, including rules governing members' financial condition, margin practice, handling of customer accounts and sales practices. The Single Member SRO would be solely responsible for establishing membership rules, inspecting members for compliance with member-related rules and taking enforcement action against those members that fail to comply. Each SRO that operates a market would be solely responsible for its own market operations and market regulation.

While the Hybrid model would eliminate duplicative regulation with respect to membership rules, the model is beset by several flaws:

- Reduction in Market Knowledge. By severing the Single Member SRO from market operations, the model would reduce the Single Member SRO's knowledge of business practices. The resultant effect could be self-regulatory rules and practices that are not responsive or properly tailored.

- Jurisdictional Issues. As the Commission notes, the model could raise jurisdictional, or boundary, issues between "member" and "market" rules, in that each SRO rule would have to be characterized as either a member or market rule. In certain instances, the line between membership and trading issues may be difficult to determine. For instance, while rules relating to capital requirements may clearly fit within the jurisdiction of the Single Member SRO, other rules, such as front-running, may have both trading and non-trading characteristics. With respect to these rules, both the Single Member SRO and the market centers may have a legitimate interest in the development, surveillance and enforcement of such rules.

- Perceived Conflicts May Continue to Persist. While perceived conflicts of interest in the securities arena may be reduced with respect to non-market-related oversight, SROs could still establish market-related rules that disadvantage members that operate competing markets.

- Self-Regulation Funding Concerns. The model could promote regulatory funding issues, in that the Single Member SRO would likely be required to depend solely upon regulatory fees for funding or the market centers would have to contribute to the Single Member SRO (both of which could operate as a tax on trading).

- Bureaucratic. As an entity that would operate free of competition, the Single Member SRO could become bureaucratic and intransigent to market developments. Such a lack of competition could, in turn, lead to a lack of innovation and higher costs to market users.

- Significant Restructuring and Untested. In the Concept Release, the Commission acknowledges that implementing the model "would require [a] significant system restructuring." *See Fed. Reg.* at 71277. Such a restructuring does not appear warranted in light of the value of the current model involving demutualized exchanges and the untested nature of the Hybrid model.

D. The Competing Hybrid Model

Under the Competing Hybrid Model, market SROs would exist as in the pure Hybrid model and market regulation would be conducted separately from member regulation. Rather than one Single Member SRO, however, the approach would permit the existence of multiple competing member SROs ("Competing Member SROs"), which would be required to be registered with the Commission. Under this approach, each market SRO member would also have to be a member of one of the Competing Member SROs. A Competing Member SRO would charge its members a regulatory fee. The Competing Member SROs would be responsible for promulgating the range of member rules described in the Hybrid discussion (*e.g.*, inspecting members for compliance with member rules). Under this approach, as with the Hybrid approach, market SROs would retain their market regulatory responsibilities.

As the Commission notes, this approach has "significant drawbacks." 69 *Fed. Reg.* 71279. For example:

- Reduction in Market Knowledge. The model would reduce self-regulatory experience by separating the regulatory staff from the staff of market operations.

- Regulatory Arbitrage. The Competing Hybrid Model could encourage regulatory arbitrage. Lax regulation or inconsistent rules could be used as an incentive to attract members, which could ultimately lead to a "race to the bottom" that jeopardizes the integrity of the marketplace.

- Jurisdictional Issues. The Competing Hybrid Model would result in the same difficult boundary issue determinations between "market" and "member" rules as would be made under the Hybrid model.

- Perceived Conflicts May Continue to Persist. In the securities arena, perceived conflicts with members, issuers and shareholders would, according to the Commission, "remain unabated." 69 *Fed. Reg.* 71279. Moreover, not only could there be perceived conflicts with the securities market SROs, but there could also be perceived conflicts involving the Competing Member SROs. The model would thus move in the wrong direction with respect to perceived conflict of interest concerns.

- Self-Regulation Funding Concerns. Competition could result in an effort by the Competing Member SROs to reduce their fees in an effort to attract and keep members. Reduced fees could, in turn, promote cost-saving, but give rise to inferior self-regulatory services. Ultimately, the Commission may have to continue to be responsible for determining whether funding remained adequate.

- Significant Restructuring. The Commission acknowledges that implementing the model would involve "a significant departure from the current system." 69 *Fed. Reg.* 71278. Such a major departure is not warranted.

E. The Universal Industry Self-Regulator

Under this model, the current SROs' self-regulatory authority for all market and member rules would be transferred to one industry SRO, the Universal Industry Self-Regulator. While the model might eliminate the jurisdictional issues associated with the Hybrid models and create a level playing field among competing markets, in that they would all be subject to the same uniform standards of a single SRO, the model has major limitations. For example:

- Reduction in Market Knowledge. Separating the regulatory function of the exchanges from the operational market functions could hamper self-regulatory efforts because it would reduce the familiarity of the regulators with market practices.

- Risk of Redundancy. Removed from actual industry concerns, the Universal Industry Self-Regulator could serve as a superfluous layer of regulation that provides little additional benefit to the oversight provided by the Commission.

- No Synergy with New Trading Systems. Under the current regime of self-regulation, the nature and detail of trading-related regulation remain with the firms that are engaged in the trading activity. In transferring the trading regulatory function to a separate entity, any synergy between the market center and the regulatory function could be jeopardized. In particular, as exchanges seek to innovate, their regulatory systems might not be as well designed for effective surveillance because the regulators would not have had the opportunity to provide input into the development and implementation of the technology.

- Bureaucratic. Operating free of competition, the Universal Industry Self-Regulator could become bureaucratic and intransigent to market developments. In turn, lack of competition could hamper innovation and raise costs.

- Perceived Conflicts May Continue to Persist. While the perceived conflicts of interest in the securities arena may be reduced with respect to regulatory-related functions, SROs could still establish trading rules that disadvantage firms that operate or have an interest in competing markets. At the same time, the board of directors of the Universal Industry Self-Regulator could be subject to perceived conflicts of interest, particularly if industry leaders sit on the board of such an entity.

F. The Universal Non-Industry Regulator

Under this model, one non-industry entity that is independent, non-profit and non-governmental, would be designated to be responsible for all markets and member regulation for all members and all markets. According to the Commission, such a model might resemble the regulatory regime adopted for audits of public companies (*i.e.*, the Public Company Accounting Oversight Board). While this model might alleviate perceived conflicts of interest with members, it is beset by several drawbacks:

- Reduction in Market Knowledge. The model could reduce self-regulatory experience by separating the regulatory staff from market operations.

- Risk of Redundancy. As with the Universal Industry Self-Regulator, the Universal Non-Industry Regulator could serve as a superfluous layer of regulation that provides little benefit to the oversight provided by the Commission.

- No Synergy with New Trading Systems. As with the Universal Industry Self-Regulator, the Universal Non-Industry Regulator would not have the opportunity to tap the expertise of the market centers, which could lead to less effective and less efficient regulatory systems and processes.

G. Direct Commission Regulation of the Industry

Under this model, the SRO system would be replaced by direct Commission regulation of the industry. The model's flaws are numerous:

- Reduction in Market Knowledge; No Synergy with New Trading Systems. As discussed with respect to the Universal Industry Self-Regulator and the Universal Non-Industry Regulator above, these arguments apply to the SEC-only Model.

- Reduced Industry Involvement. Under the current regime of self-regulation, the regulated entities—both exchanges and firms—are actively involved in the regulatory process. Self-regulation encourages these entities to be participants in the regulatory process. By providing the opportunity to participate in the regulatory process, the regulated entities are not only more aware of the objectives of regulation, but have an interest in ensuring that regulation is effective. Direct Commission oversight would remove the regulated entities from the regulatory process, which could deprive the Commission of the benefit of their insight and deprive the regulated entities of direct input into the regulation that governs their business operations.

- Bureaucratic and Costly. Congress has primarily relied upon self-regulation in the securities and futures markets because of "the sheer ineffectiveness of attempting to assure [regulation] directly through the Government on a wide scale."[4] The vesting of sole regulatory authority in the Commission would involve "a pronounced expansion of the SEC, the multiplication of branch offices, a large increase in the expenditure of public funds, an increase in the problem of avoiding the evils of bureaucracy and a minute, detailed, slow and rigid regulation of business conduct by law."[5]

- Historical Lack of Success. The Commission previously administered a program in which it directly oversaw certain broker-dealers—a program that was ultimately deemed unsuccessful.[6] The so-called SECO (SEC-only) program applied to all registered broker-dealers that were not members of a national securities association, such as the NASD ("Non-Member Broker-Dealers"). Under provisions of the Exchange Act that were enacted in 1964, the SEC was given the authority to establish for Non-Member Broker-Dealers and their associated persons a regulatory regime comparable to that adopted by the NASD for its members and their associated persons. Specifically, the Commission established procedures and norms of conduct that paralleled those of the NASD with respect to the qualification of associated persons, fees and assessments, standards for employee supervision, discretionary accounts and suitability recommendations.[7]

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[4] Hearing on H.R. 7852 and H.R. 8720 Before the House Committee on Interstate and Foreign Commerce, 73rd Cong., 1st Sess. at 514 (testimony of John Dickinson).

[5] S. Rep. No. 1455, 75th Cong., 3d Sess. 3 (1938).

[6] *See* 69 *Fed. Reg.* 71282, 71267; Securities Industry Association, *Reinventing Self-Regulation* (October 14, 2003).

[7] Exchange Act Rel. No. 32018 (Mar. 25, 1993), 58 *Fed. Reg.* 16151-01 (1993).

> In 1983, Congress abolished the SECO program and the Commission rescinded the applicable rules.[8] In testimony before the House Subcommittee, former Commission Chairman John Shad testified that a comprehensive management study of the SECO program concluded that the SECO program was unnecessarily costly and diverted the Commission's limited resources away from areas of greater importance.[9]
>
> In this respect, we also note that the failure by the Commission was specifically examined by the CFTC in connection with the CFTC's review of the National Futures Association's application for registration.[10] Based upon the examination, the CFTC determined that a program that required direct CFTC regulation for certain FCMs would not only be difficult to administer, but that the CFTC would lack sufficient resources to devote to such regulation.[11]

Conclusion

In a recent speech, Chairman Donaldson extolled the benefits of the self-regulatory system, stating that:

> Our securities markets have historically operated under a system of self-regulation. In 1934, when Congress gave the Commission authority over securities exchanges, it recognized the important role they had already assumed in overseeing their members' activities, imposing rule of conduct, and punishing wrongdoing. The fundamentals of self-regulation have changed little since that time. Oversight of our securities markets and market participants remains grounded in the principle that regulation works best when it occurs close to the regulated activity."[12]

CME shares Chairman Donaldson's view and believes that a self-regulatory system involving demutualized exchanges is time-tested, flexible and efficient, and the best system available to the industry.

Thank you for the opportunity to comment upon the Commission's study. If you have any questions or comments, please do not hesitate to contact me or Matthew F. Kluchenek, Director and Associate General Counsel, at (312) 338-2861.

Sincerely,

Craig S. Donohue

Craig S. Donohue

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[8] *See* Public Law 98-38, Sec. 3, 97 Stat. 205, 206-07 (1983), codified at Sections 15(b)(8) and 15(b)(9). *See also* Exchange Act Rel. No. 20409 (Nov. 22, 1983), 48 *Fed. Reg.* 53688 (1983).

[9] The House Committee report stated "that any attempt to put SECO regulation on a par with that provided by the NASD would require significant expenditures by the Commission for additional staff and administrative costs." H.R. Rep. No. 98-106, at 7 (1983).

[10] Registered Futures Associations; Mandatory Memberships, 48 *Fed. Reg.* 26304 (1983).

[11] *Id.*

[12] Speech by SEC Chairman: Open Meeting Regarding SRO Governance Rule Proposal, Nov. 9, 2004.