



## U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of  
Market Oversight

### DESIGNATION MEMORANDUM

February 10, 2004

**To:** The Commission

**From:** The Division of Market Oversight

**Subject:** Application of HedgeStreet, Inc. for Designation as a Contract Market pursuant to Sections 5 and 6(a) of the Commodity Exchange Act.

**Recommendation:** Staff recommends that the Commission designate HedgeStreet as a contract market and simultaneously approve HedgeStreet Rules 1.1-1.8, 2.1-2.5, 3.1-3.13, 4.1-4.3, 5.1-5.2, 6, 7.1-7.7, 8.1-8.5, and 9.1-9.3 (“Rulebook”).

**Concurring:** Division of Clearing and Intermediary Oversight  
The Office of the General Counsel

**Consulting:** The Division of Enforcement  
Office of the Executive Director

**Responsible Staff:** Thomas Leahy x5278  
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#### I. Overview

HedgeStreet, Inc. (“HedgeStreet” or “Exchange”) has applied to the Commodity Futures Trading Commission (“Commission”) for designation as a contract market and for registration as a derivatives clearing organization (“DCO”).<sup>1</sup> HedgeStreet stated in its application that it plans to provide for the automated trading of option contracts.

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<sup>1</sup> The Division of Clearing and Intermediaries Oversight has prepared a separate document including a recommendation regarding HedgeStreet’s application for registration as a DCO.

HedgeStreet describes its intended contracts as European-style binary options, which could be purchased directly from HedgeStreet in individual bundles consisting of two components, a call option and a put option.<sup>2</sup> HedgeStreet would be the only source of contract bundles and would be the only writer of options. Each bundle, consisting of a put option and a call option, would be priced by HedgeStreet at \$10. The owner of a bundle could sell either or both component options through HedgeStreet's trading system. Each transaction must be fully paid; that is, there would be no margining of positions on HedgeStreet. Upon expiration, the component option that is in the money would pay \$10 and the other component option would be worthless. Access to the Exchange's trading system would be through computer-to-computer interface via the internet.

The Exchange anticipates that its contracts would allow institutions and individuals risk management opportunities that existing exchanges do not provide, although HedgeStreet did not file any contracts with its application.<sup>3</sup> The Exchange has contracted with the National Futures Association ("NFA") to assist it in carrying out various self-regulatory responsibilities with respect to, among other things, market surveillance, trade practice surveillance, and investigative and disciplinary functions.<sup>4</sup> The NFA also would provide its arbitration forum for the resolution of disputes between members and between HedgeStreet and its members.

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<sup>2</sup> A European-style option may be exercised at expiration only. A binary option is a cash-settled option with a fixed payout rather than a payout based on how deep the option is in the money. See *infra* Section V for a description of HedgeStreet's bundles and options.

<sup>3</sup> However, Division of Market Oversight staff understands that the contracts HedgeStreet intends to list for trading would be similar in design to contracts offered by "event markets." In this regard, as discussed above, the contracts are binary options. HedgeStreet has stated, however, that it intends to list only contracts that have a legitimate economic purpose and does not intend to list for trading contracts based on terrorist activity or gambling activities, such as the outcome of sporting events.

<sup>4</sup> The NFA's contract with HedgeStreet provides for the provisions of services appropriate for offering more traditional products. For instance, NFA has undertaken to monitor deliverable supplies. HedgeStreet, however, has represented that its contracts will have no underlying cash market. Staff understands the regulatory services contract was drafted to cover a wider set of products than those that HedgeStreet

HedgeStreet intends to use the onExchange Board of Trade's ("ONXBOT") Extensible Clearing System ("ECS") as its trading system and, in this regard, it has provided to the Commission its license agreement with ONXBOT.<sup>5</sup> In addition, HedgeStreet contracted with USinternetworking ("USi") to provide information technology and operations management for the HedgeStreet system.<sup>6</sup>

Concurrent with its application for designation as a contract market, HedgeStreet also applied for registration as a DCO. HedgeStreet states that it would ensure the movement of funds to and from segregated accounts at its settlement bank as appropriate, and would keep records of all member and trade-specific accounting and other information.<sup>7</sup>

As part of its application, HedgeStreet submitted to the Commission a proposed trade-matching algorithm, procedures and rules pertaining to Exchange governance, disciplinary and arbitration procedures, trading standards, recordkeeping requirements, and various other materials to meet the requirements for a board of trade seeking designation as a contract market. As noted, HedgeStreet intends to use as its trading system the ONXBOT ECS, which was the trading system for the onExchange Board of Trade, Inc. designated contract market.

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initially intends to offer, and that NFA will provide whatever services are appropriate to the products actually offered by HedgeStreet.

<sup>5</sup> The Commission designated ONXBOT as a contract market on December 22, 2000. However, ONXBOT has not listed any contracts for trading and is currently dormant. If ONXBOT were to seek to list contracts for trading, it would be required to apply to have its designation reinstated pursuant to Commission Regulation 38.3(a) and 38.4.

<sup>6</sup> USintenetworking provides similar services to EnergyClear Operations Company, which provided operations on behalf of EnergyClear Corporation. The Commission registered EnergyClear Corporation as a DCO on July 9, 2001.

<sup>7</sup> HedgeStreet contracted with The Union Bank of California to act as the settlement bank. The application included letters from Union Bank of California to HedgeStreet that specify the services that the settlement bank will provide to HedgeStreet.

As part of its application, HedgeStreet also submitted an undertaking that HedgeStreet and persons acting on its behalf will not engage in fraudulent conduct. Since HedgeStreet will be a nonintermediated market, this undertaking will help to ensure that HedgeStreet customers receive antifraud protection analogous to the antifraud protection applicable to more traditional markets.<sup>8</sup>

Based upon its review of the entire application and the complete record in this matter, and all public comments received by the Commission with respect to the application, the Division of Market Oversight (“DMO” or “Division”) has determined that HedgeStreet’s application demonstrates compliance with the designation criteria of Section 5(b) of the Commodity Exchange Act (“Act”), the core principles of Section 5(d) of the Act, and the common provisions of Section 5c(b) of the Act regarding designation of contract markets. Accordingly, staff recommends that the Commission designate HedgeStreet as a contract market and simultaneously approve HedgeStreet Rules 1.1-1.8, 2.1-2.5, 3.1-3.13, 4.1-4.3, 5.1-5.2, 6, 7.1-7.7, 8.1-8.5, and 9.1-9.3 (“Rulebook”).

## **II. Procedural Background**

HedgeStreet initially applied for designation as a contract market and registration as a DCO on March 12, 2001. Pursuant to a May 4, 2001 request by HedgeStreet, on May 14, 2001, the Division of Trading and Markets and the Division of Economic Analysis (“Divisions”)<sup>9</sup>

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<sup>8</sup> Staff considered the application of the Bank Secrecy Act (“BSA”), as amended by the USA Patriot Act, to HedgeStreet. In this regard, DCMs and DCOs are not among the specifically identified “financial institutions” subject to BSA requirements. HedgeStreet noted in its application that: (1) the settlement bank, Union Bank of California (“UBC”), would only accept funds from a U.S. bank, savings and loan, credit union or similar entity, all of which are subject to BSA requirements; and (2) UBC itself has in place a program to combat money laundering as required by the BSA. Moreover, HedgeStreet has advised staff that it intends to retain an outside firm to conduct customer background checks, which would help to address similar concerns.

<sup>9</sup> On February 1, 2002, the Commission announced a reorganization of the functions that were performed by the Division of Trading and Markets and the Division of Economic Analysis. Under that reorganization,

terminated review of HedgeStreet's application under the 60-day fast-track review procedure of then-proposed Parts 38 and 39, and stayed the 180-day period for review of HedgeStreet's contract market application under Section 6 of the Act.

On March 21, 2002, HedgeStreet resubmitted its applications for contract market designation and registration as a DCO. The Divisions terminated review of those applications in correspondence dated April 19, 2002 under the 60-day fast-track review procedure of Parts 38 and 39, stayed the 180-day period for review of HedgeStreet's contract market application under Section 6 of the Act, and provided HedgeStreet with a list of deficiencies. On April 30, 2002, HedgeStreet filed an Amended Application for Designation as a Contract Market ("Amended Application") that included, as appendices, an Amended Rulebook, a Form of Agreement Between eSpeed and HedgeStreet (unsigned), a HedgeStreet Draft Membership Account Application, and a HedgeStreet Regulatory Chart. HedgeStreet further amended this application on June 12, 2002 ("Second Amended Application"). The June 12, 2002 submission also included amendments to HedgeStreet's Rulebook, and modifications to the HedgeStreet Draft Membership Account Application. On August 2, 2002, the Division stayed the 180-day review period for HedgeStreet's application under Section 6 of the Act.

On September 22, 2003, HedgeStreet resubmitted its application for designation as a contract market and registration as a DCO. On October 27, 2003, at HedgeStreet's request, the Commission stayed the 180-day review period under Section 6 of the Act. On December 19, 2003, HedgeStreet resubmitted its applications for contract market designation and registration as a DCO. In addition, since filing its initial application for designation as a contract market, HedgeStreet has supplemented its submission via correspondence and e-mails dated November

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those functions would be performed by two new operating divisions, DMO and the Division of Clearing and Intermediary Oversight, and the Office of the Chief Economist.

15, 2001; February 2, 5, and 12 and June 20, 2002; October 7, 27 and 31, November 5 and 19, 2003; and January 12 and 22, and February 2, 3, 5, 6, and 10, 2004. The statutory review period ends on February 17, 2004.

The Commission posted portions of the HedgeStreet application on its website on September 29, 2003 with a request for public comment.<sup>10</sup> That comment period ended on October 14, 2003. The Commission received five comment letters in response to this request for comment. The Commission also received a response to the public comment letters from HedgeStreet.

The remainder of this memorandum consists of charts describing in detail how the applicant meets the requirements of the designation criteria and core principles and a discussion of the application and the comments thereon. Sections III and IV, respectively, describe in detail how the applicant meets the requirements of the designation criteria and core principles. Section V includes a discussion of noteworthy and novel issues presented by the HedgeStreet application. Section VI summarizes and provides the staff's analysis of the comments received in response to the application. Section VII discusses HedgeStreet's undertaking. Section VIII contains a consideration of costs and benefits under Section 15(a) of the Act. Finally, Section IX lists the supporting documents to this memorandum.

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<sup>10</sup> HedgeStreet had filed its application with a request for confidential treatment. Subsequently, at the request of Division staff, HedgeStreet lifted the request for confidential treatment on its proposed rules and its Regulatory Chart, and those documents were then posted on the Commission's website.

**III. Analysis of HedgeStreet’s Contract Market Application and Proposed Rules for Compliance with the Act’s Designation Criteria for Contract Markets**

<b>CONTRACT MARKET CRITERIA FOR DESIGNATION</b>	<b>HEDGESTREET PROPOSAL</b>	<b>STAFF ANALYSIS</b>
<p><b>Sec. 5(a) Applications</b> – “A board of trade applying to the Commission for designation as a contract market shall submit an application to the Commission that includes any relevant materials and records the Commission may require consistent with this Act.”</p>	<p>Submissions dated December 19, 2003 through February 3, 2004.</p>	<p>Acceptable.  <i>See Attachments.</i></p>
<p><b>Sec. 5(b) CRITERIA FOR DESIGNATION</b></p>		
<p><b>Designation Criterion 1 <i>In General</i></b> – “To be designated as a contract market, the board of trade shall demonstrate to the Commission that the board of trade meets the criteria specified in this subsection.”</p>	<p>HedgeStreet’s submissions dated December 19, 2003 through February 3, 2004, include, among other things, the HedgeStreet Contract Market Application, Rulebook, Agreement Framework between HedgeStreet and onExchange, Master Agreement for iMap Services between HedgeStreet and USinternetworking, HedgeStreet Membership Account Application, Regulatory Chart, HedgeStreet/NFA Regulatory Services Agreement (“RSA”) and documents relating to the trading system.</p>	<p>Acceptable.  <i>See Attachments.</i></p>
<p><b>Designation Criterion 2 <i>Prevention of Market Manipulation</i></b> – “The board of trade shall have the capacity to prevent market manipulation through market surveillance, compliance, and enforcement practices and procedures, including methods for conducting real-time monitoring of trading and comprehensive and accurate trade reconstructions.”</p>	<p>Rule 3.13(k) specifically bars price manipulation. Rule 3.13(i) specifically bars any activity that affects the integrity of the market or its underlying systems.</p> <p>HedgeStreet has entered into an agreement with NFA to assist it in carrying out various self-regulatory responsibilities with respect to market surveillance. (<i>See HedgeStreet/NFA RSA</i>)</p> <p>In addition, HedgeStreet has provided a statement of the requirements for the positions within its compliance department and has hired a compliance director who meets those requirements.</p>	<p>Acceptable.</p> <p>NFA has been contracted to provide similar market surveillance procedures to the Merchants’ Exchange (“ME”), ONXBOT, BrokerTec, Island, and U.S. Futures Exchange (USFE), five markets that have been granted designated contract market status by the Commission.</p> <p>NFA has established procedures designed to reveal violations of various trading abuses, including attempts to manipulate prices. HedgeStreet’s</p>

CONTRACT MARKET CRITERIA FOR DESIGNATION	HEDGESTREET PROPOSAL	STAFF ANALYSIS
		<p>monitor overall activity in each market on a real-time basis and oversee NFA’s surveillance activities. NFA will provide HedgeStreet with data regarding positions of large traders, deliverable supplies and futures and cash prices, as appropriate to the products traded. The market surveillance conducted by NFA is specified in Schedule A of the RSA.</p>
<p><b>Designation Criterion 3 <i>Fair and Equitable Trading</i></b>  – “The board of trade shall establish and enforce trading rules to ensure fair and equitable trading through the facilities of the contract market, and [sic] the capacity to detect, investigate, and discipline any person that violates the rules. The rules may authorize – (A) transfer trades or office trades; (B) an exchange of futures – (i) futures in connection with a cash commodity transaction; (ii) futures for cash commodities; or (iii) futures for swaps; or (C) a futures commission merchant, acting as principle or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if the contract is reported, recorded or cleared in accordance with the rules of the contract market or a derivatives clearing organization”</p>	<p>Rule 3.13(b) prohibits entering into any trade that has been directly or indirectly pre-arranged. Rule 3.13(c) prohibits entering into any trade that does not result in a change in beneficial ownership, that is designed to unnaturally inflate trading volume, that in any way attempts to circumvent the Market’s order processing, trade ordering, and trade execution systems, or otherwise to circumvent exposure of the order to open and competitive bidding on the Market, or that has some other illegitimate purpose. Rule 3.13(k) prohibits engaging in activity that would violate the CEA or the Commission’s Regulations.</p>	<p>Acceptable.</p> <p>HedgeStreet’s rules specifically prohibit prearranged trading and wash trading.</p> <p>Because the HedgeStreet market prohibits intermediation, trading abuses related to intermediation are unlikely to occur. While HedgeStreet rules do not specifically prohibit trading ahead and taking the other side, HedgeStreet’s rules do prohibit any activity that would violate the CEA or the Commission’s regulations. Additionally, NFA intends to monitor for abuses such as trading ahead and taking the other side.</p> <p>The HedgeStreet market would not allow transfer trades, office trades, EFPs, EFSs, or block trades.</p> <p>HedgeStreet will have a dedicated compliance department to investigate reports from NFA or from other sources, of unusual trading activity or other activity that could constitute a violation of HedgeStreet’s rules. As it does for other exchanges, NFA will run its trade practice and market surveillance program on the audit data generated by the HedgeStreet system, review any exception reports generated by that program, and notify HedgeStreet’s</p>



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		investigation is warranted. <i>See</i> Designation Criteria 6 for detailed description of HedgeStreet’s Investigation and Disciplinary Procedures.
<p><b>Designation Criterion 4 Trade Execution Facility</b> – “The board of trade shall (A) establish and enforce rules defining, or specifications detailing, the manner of operation of the trade execution facility maintained by the board of trade, including rules or specifications describing the operation of any electronic matching platform; and (B) demonstrate that the trade execution facility operates in accordance with the rules or specifications.”</p>	<p>Rule 3.8; Application, Appendix D – Licensing and Support Agreement with ONXBOT, dated August 7, 2003; Application, Appendix F – Hosting Agreement with USi, dated November 6, 2003; ONXBOT responses to CFTC Technical Review of Electronic Trading Systems, dated October 11, 2000; ONXBOT response to CFTC request for current technical information, dated August 18, 2003, including ONXBOT ECS Release Notes dated July 2003; ONXBOT ECS Administrator’s Guide.</p>	<p>Acceptable.</p> <p>Rules 3.2 through 3.12 of Appendix A (Rules) of the HedgeStreet application describe the procedures and operation of the electronic matching platform. Orders would be executed in accordance with a price-time priority algorithm, meaning that the best bid or offer will have priority over all other bids or offers, and bids or offers entered at the same price will be executed in the order they were received by the system. All limit orders entered into the system would identify quantity and price. Orders would be filled and executed in the sequence in which they were received on an “or better” basis. As such, limit orders would be recorded and logged into the server as they were received and would be assigned order entry times to a precision of no worse than the nearest one-thirtieth of one second. Staff notes that the ECS time-stamping function normally would be capable of greater precision, usually milliseconds. This algorithm is substantially similar to those previously approved by the Commission for other electronic trading systems.</p> <p>HedgeStreet intends to use the ONXBOT Extensible Clearing System (ECS), a system reviewed and approved by the Commission in December 2000. HedgeStreet and ONXBOT have provided information regarding the changes to that approved system, and staff of the Commission’s Office of Information Resources Management has determined that the current system operates in accordance with HedgeStreet’s rules and specifications</p>

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		<p>On Wednesday, January 28, 2004, Commission staff conducted an onsite visit to the data center and operations areas for the purpose of observing first-hand the trading system. Staff found that the system operated in accordance with HedgeStreet Rules 3.2 - 3.11 and specifications described in the Application.</p>
<p><b>Designation Criterion 5 <i>Financial Integrity of Transactions</i></b> – “The board of trade shall establish and enforce rules and procedures for ensuring the financial integrity of transactions entered into by or through the facilities of the contract market, including the clearance and settlement of the transactions with a derivatives clearing organization.”</p>	<p>Application. HedgeStreet would not credit a contract bundle to the account of any member until the member had paid for the contract bundle in full in immediately available funds. HedgeStreet will ensure the movement of funds from accounts as appropriate. All member funds would be kept in appropriately titled customer segregated accounts.</p>	<p>Acceptable</p> <p>HedgeStreet has submitted a concurrent application to become a registered DCO.</p>
<p><b>Designation Criterion 6 <i>Disciplinary Procedures</i></b> – “The board of trade shall establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market participants that violate the rules of the board of trade, or similar methods for performing the same functions, including delegation of the functions to third parties.”</p>	<p>Rulebook Chapter 7 (Rule Enforcement) includes rules and procedures relating to rule enforcement, including summary and non-summary disciplinary actions; Application, pp. 25-32 (Compliance and Rule Enforcement).</p>	<p>Acceptable. HedgeStreet intends to operate its own Compliance Department that will include at least one compliance officer responsible for conducting investigations. HedgeStreet states that its compliance officer will have at least three years experience in the regulation of exchange trading practices and would not be subject to disqualification under Commission Rule 1.63(b). HedgeStreet has hired a Compliance Officer that meets these qualifications.</p> <p>HedgeStreet will hire hearing officers, who will be lawyers that specialize in commodities regulation, on an “as needed” basis.</p> <p>Disciplinary procedures for non-summary and summary disciplinary actions are set forth in Chapter 7 of HedgeStreet’s rules and would be consistent with Commission regulations and interpretive guidance regarding core principles.</p>

CONTRACT MARKET CRITERIA FOR DESIGNATION	HEDGESTREET PROPOSAL	STAFF ANALYSIS
		<p>The compliance officer would investigate possible rule violations and at the conclusion of an investigation draft a document detailing the facts of the investigation and the compliance officer's analysis and conclusion. If the compliance officer concludes that a member violated HedgeStreet's rules, he or she will submit findings to the member who is the subject of the investigation. If the findings are not contested, HedgeStreet will accept the findings and levy a sanction against the member. If the member contests the findings, the member will forward a response to those findings and/or sanction to the Compliance Officer within 15 days. The Compliance Officer's report and the member's response will be forwarded to a hearing officer who will conduct a telephonic hearing, and after that hearing, issue findings and, if appropriate, levy a sanction against the member. Hearing officers and compliance officers may not communicate regarding a matter brought before the hearing officer without informing the Member who is the subject of the communication of its substance and allowing the Member an opportunity to respond.</p> <p>The sanctions that may be imposed for a violation of HedgeStreet's rules will include: a letter of warning, censure, or reprimand; suspension, in whole or in part, of membership privileges; and termination, in whole or in part, of membership privileges. The violations that would normally result in suspension or termination of membership include: supplying false information in an application for a HedgeStreet account; trading for another person or entity (other than the company for which a representative may be registered to trade); behaving in a manner that</p>

CONTRACT MARKET CRITERIA FOR DESIGNATION	HEDGESTREET PROPOSAL	STAFF ANALYSIS
		underlying systems; failure to abide by an arbitration award; or any other reason necessary to protect HedgeStreet, its members, or the public.
<p><b>Designation Criterion 7 <i>Public Access</i></b> – “The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade.”</p>	<p>Application, p. 25. HedgeStreet noted that it will post all rules and contract specifications on its web site.</p>	<p>Acceptable.</p> <p>Members and non-members will have access to HedgeStreet rules and contract specifications.</p>
<p><b>Designation Criterion 8 <i>Ability to Obtain Information</i></b> – “The board of trade shall establish and enforce rules that will allow the board of trade to obtain any necessary information to perform any of the functions described in this subsection, including the capacity to carry out such international information-sharing agreements as the Commission may require.”</p>	<p>Rules 2.1, 2.2 and 7.1; Application pp 5 &amp; 6. Membership Account Application (Appendix B); Regulatory Chart (Appendix C).</p>	<p>Acceptable.</p> <p>Applicants would be required to complete a HedgeStreet membership account application. HedgeStreet will maintain these applications, which members must update pursuant to Rule 2.2. Failure to update applications may result in suspension or revocation of trading privileges. Members must agree to make available to HedgeStreet financial or other information that HedgeStreet may request or as may be required to respond to a request for information from the Commission or other regulatory bodies. Moreover, members must cooperate promptly and fully with HedgeStreet and/or the Commission in any investigation, call for information, inquiry, audit, examination, or proceeding. <i>See</i> Rule 2.2(a). Members consent to allow HedgeStreet to provide all information HedgeStreet has concerning members, including trading activity, to the Commission, or any other regulatory agency, law enforcement authority, or judicial tribunal having jurisdiction. <i>See</i> Rule 2.2(b). HedgeStreet’s trading system also will store all order and trade data in a read-only, searchable database. <i>See</i> Rule 7.1.</p> <p>Commission staff has determined that HedgeStreet</p>

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		respect to the products it intends to list at this time. HedgeStreet has represented that it will carry out such information-sharing agreements that the Commission determines to be appropriate to HedgeStreet.

**IV. Analysis of HedgeStreet’s Proposed Rules with the Act’s Core Principles for Designation as a Contract Market.**

CONTRACT MARKET CORE PRINCIPLES	HEDGESTREET PROPOSAL	STAFF ANALYSIS
<p><b>Sec. 5c(b) Common Provisions Applicable to Registered Entities</b>  <b>(1) In General</b> – “A contract market or derivatives transaction execution facility may comply with any applicable core principle through delegation of any relevant function to a registered futures association or another registered entity.”  <b>(2) Responsibility</b> – “A contract market or derivatives transaction execution facility that delegates a function under paragraph (1) shall remain responsible for carrying out the function.”</p>	<p>Trade practice surveillance, post-trade market surveillance, and dispute resolution services will be contracted out to NFA. Real-time market surveillance will be conducted by HedgeStreet staff. HedgeStreet also is seeking registration as a DCO and has contracted with Union Bank of California to act as the settlement bank. <i>See</i> HedgeStreet/NFA RSA and letters from Union Bank of California to HedgeStreet dated September 10, 2003 and September 15, 2003.</p>	<p>Acceptable.</p> <p>HedgeStreet would be responsible for compliance with designation criteria and core principles.</p>
<p><b>SEC. 5c(c) NEW CONTRACTS, NEW RULES, AND RULE AMENDMENTS –</b>  <b>(1) In General</b> – Subject to paragraph (2), a registered entity may elect to list for trading or accept for clearing any new contract or other instrument, or may elect to approve and implement any new rule or rule amendment, by providing to the Commission (and the Secretary of the Treasury, in case of a contract for sale of a government security for future delivery (or an option on such a contract) or a rule or</p>	<p>Rulebook, Chapters 1-9.</p>	<p>Acceptable.</p> <p>HedgeStreet has requested that the Commission approve its proposed rules, which are set forth in its Rulebook, chapters 1-9. The Division recommends such approval pursuant to Section 5c(c)(2)(A) of the Act, since the rules contained in HedgeStreet’s Rulebook do not violate any provision of the Act or the Commission’s regulations.</p>

CONTRACT MARKET CORE PRINCIPLES	HEDGESTREET PROPOSAL	STAFF ANALYSIS
<p>contract) a written certification that the new contract or instrument or clearing of the new contract or instrument, new rule, or rule amendment complies with this Act (including regulations under this Act).</p> <p><b>(2) Prior Approval –</b>  <b>(A) In General</b> – A registered entity may request that the Commission grant prior approval to any new contract or other instrument, new rule, or rule amendment.</p>		
<p><b>Core Principle 1 In General</b> – “To maintain the designation of a board of trade as a contract market, the board of trade shall comply with the core principles specified in this subsection. The board of trade shall have reasonable discretion in establishing the manner in which it complies with the core principles.”</p>	<p>HedgeStreet’s submissions dated December 19, 2003 through February 5, 2004, include, among other things, the HedgeStreet Contract Market Application, Rulebook, Agreement Framework between HedgeStreet and onExchange, Master Agreement for iMap Services between HedgeStreet and USinternetworking, HedgeStreet Membership Account Application, Regulatory Chart, HedgeStreet/NFA RSA, and documents relating to the trading system.</p>	<p>Acceptable.</p>
<p><b>Core Principle 2 Compliance with Rules</b> – “The board of trade shall monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.”</p>	<p>HedgeStreet compliance and rule enforcement will be conducted through a dedicated compliance department and through its agreement with NFA, whereby NFA will assist with certain compliance functions (Appendix H – Regulatory Services Agreement (“RSA”). Application pp. 25 (Compliance and Rule Enforcement)</p> <p>Because of the nature of the HedgeStreet market and the contracts it intends to trade, many rules and compliance procedures required of traditional contract markets would be inapplicable to the HedgeStreet trading system and contracts. In this</p>	<p>Acceptable.</p> <p>Schedule A of that agreement, “Scope of Regulatory Services,” provides that NFA will utilize an automated system to perform trade practice surveillance for HedgeStreet. NFA’s trade practice surveillance system will monitor for the following types of transactions: Trading ahead, Taking the other side (while trading ahead and taking the other side are generally abuses that occur in intermediated markets, NFA intends to be pro-active in monitoring the market for such abuse in the scenario that a market participant would try to circumvent the prohibition on maintaining more than one account and either trade ahead of or take the other side of</p>

CONTRACT MARKET CORE PRINCIPLES	HEDGESTREET PROPOSAL	STAFF ANALYSIS
	<p>intermediated, rules prohibiting intermediaries from acting adversely to a member/customer's interests are unnecessary. Additionally, because HedgeStreet's contracts would be potentially unlimited in number and would not require delivery of the underlying interest, manipulative activity such as squeezes or corners likely would be impossible. Because orders would be automatically executed and recorded, prohibitions on changing floor orders or creating false trades would be unnecessary. Application p. 28 (Prohibited Actions)</p> <p>Rules and sections of the application that are applicable are included in: Application, p. 22-23 (Recordkeeping and Retention); pp.25-32 (Compliance and Rule Enforcement); Rule 2.2(a) (Member Obligations) members and authorized representatives must comply with HedgeStreet rules, CEA, and Commission regulations; Rule 2.4 (Authorized Representatives); Rule 3.13 (Prohibited Transactions and Activities); Rule 7.1 (Monitoring the Market); Rule 7.2 (Investigations, Hearings, and Appeals); Rule 7.3 (Settlement of Investigations); Rule 7.5 (Penalties); and Rule 7.6 (Summary Suspension). Appendix C to Second Amended Application (Regulatory Chart).</p> <p>HedgeStreet has retained a full-time Compliance Officer with significant compliance experience and will hire lawyer(s) that specialize in commodities regulation from one or more outside law firms on an</p>	<p>orders for those other accounts), Wash Trading, Pre-arranged Trading, Money Passing, Counter-party Trade Percentages, Marking the Close, Trade Cancellation, Market Events, User Logon/logoff, Information from Market Participants, and Trader Profiles. *</p> <p>In addition, pursuant to the RSA, NFA will perform market surveillance to monitor the following: the basis relationship between the exchange product and the corresponding underlying market as appropriate to the products traded, the price relationship between the exchange product and any related contracts on the same or different exchanges, and the spread relationship between different months in the same exchange product. NFA's market surveillance system will monitor and analyze holdings of members to guard against corners and squeezes.</p> <p>If NFA detects potential irregularities during their review of exception reports generated by its system, NFA may make preliminary factual inquiry of HedgeStreet members to evaluate the likelihood that a rule violation has occurred. In that regard, NFA may: (1) review any trades in question in relation to other surrounding trades; (2) gather additional information from HedgeStreet members and market participants; (3) review activity in relationship to other related markets (cash and other derivative markets); and (4) confer with HedgeStreet's Compliance Director about the exchange's customs and practices.</p> <p>If, after initial investigation, NFA's Compliance Department has reason to believe that a matter should be further investigated, the Compliance Department shall refer the matter to HedgeStreet's Compliance Department. NFA's Compliance Department staff</p>

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	<p>Application pp. 25-32 (Compliance &amp; Rule Enforcement)</p>	<p>HedgeStreet’s Compliance Director. If HedgeStreet’s Compliance Director fails to conduct an investigation, then HedgeStreet’s Compliance Director shall notify NFA’s Compliance Department in writing of this decision and the reasons for the decision. To the extent that the HedgeStreet Compliance Director’s determination differs in any respect from NFA’s recommendation that an investigation be conducted, then the HedgeStreet Compliance Director shall note NFA’s recommendation and provide an explanation as to why HedgeStreet disagrees with NFA’s recommendation.</p> <p>Should HedgeStreet determine to proceed with an investigation, HedgeStreet’s investigative procedures become applicable at that time. HedgeStreet’s investigative procedures include documenting: (1) the facts that led to the opening of the investigation, including any details provided by NFA or other source; (2) the facts that were found during the investigation; and (3) the Compliance Officer’s analysis and conclusion. Based on that information, the Chief Compliance Officer will make a determination as to whether there are reasonable grounds to believe that a Member has violated any HedgeStreet rules or applicable statutes or regulations.</p> <p>If the Compliance Officer determines there are reasonable grounds to believe that the Member has violated any HedgeStreet rules or applicable statutes or regulations, HedgeStreet will document the analysis and conclusions in an Investigation Summary that will be forwarded to the Member whose activity is the subject on the investigation via email. The content of that e-mail will include the following</p>



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		<p>begun; (2) the charges or a summary of the charges; (3) the response, if any or a summary of the response; (4) a summary of the investigation conducted; (5) findings and conclusions as to each charge, including which of the Rules the Member or its authorized representative violated, if any; and (6) the penalty, if any, proposed by the compliance officer.</p> <p>The Member will have 15 calendar days to respond to the findings of the Compliance Department. If the findings of the compliance officer are not contested by the Member, HedgeStreet will deem those findings admitted by the Member and impose the penalty (if any) proposed by the compliance officer. If the findings of the compliance officer are contested, the compliance officer's report and the Member's response will be submitted to a HedgeStreet hearing officer who will conduct a telephonic hearing, and after that hearing, issue findings and, if appropriate, levy a sanction against the member.</p> <p>HedgeStreet has established acceptable procedures, clear and fair standards, and reasonable timelines for both summary and non-summary disciplinary actions. <i>See</i> Designation Criteria 6 for further description.</p> <p>*Although HedgeStreet will be dependent on NFA's automated surveillance, HedgeStreet will also conduct certain real time surveillance activities. Specifically, the Compliance Department will generally monitor the market, especially for events that do not comply with historical trading patterns (once established) or that may indicate that the market is experiencing unusual stress or other problems, will use the automated surveillance already available on ECS to detect trades that fail because a member has insufficient funds or contracts to complete the trade (which is a violation of Rule 3.13(a)) and will</p>

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		<p>Additionally, members must certify that they will trade only for themselves or the company for which they are registered and will not trade as an intermediary for others. HedgeStreet would police its one-account-per-member rule by routinely scanning its account database for identical names, telephone numbers, social security numbers, and other identifying characteristics.</p>
<p><b>Core Principle 3</b> <i>Contracts Not Readily Subject to Manipulation</i> – “The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.”</p>	<p>Application, p. 5 (Method of Listing New Contracts) and Appendix C to the Application, Regulatory Chart. Rule 3.13(k) specifically bars price manipulation. Rule 3.13(h) specifically bars any activity that affects the integrity of the market or its underlying systems</p> <p>HedgeStreet stated that its contracts will be designed to be not readily susceptible to manipulation. In that regard, HedgeStreet intends to list contracts that are cash settled, that have no underlying cash market, and that have no deliverable supply. Additionally, an unlimited supply of the contract bundles can be originated by purchasing them from HedgeStreet.</p>	<p>Acceptable.</p> <p>Not applicable at this time. HedgeStreet did not submit any contracts with its Contract Market Designation Application. HedgeStreet intends to submit contract terms and conditions, pursuant Section 5c(c) of the Act, after it has been designated as a contract market. Consistent with the Act and Commission regulations, Commission staff will conduct an appropriate review once contracts are submitted.</p>
<p><b>Core Principle 4</b> <i>Monitoring of Trading</i> – “The board of trade shall monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.”</p>	<p>Application pp. 25-32, Appendix C to the Application, Rule 7.1, and the HedgeStreet/NFA RSA.</p> <p>HedgeStreet will be responsible for monitoring overall activity in each market on a real-time basis. NFA will provide for monitoring of large trader positions, deliverable supplies, and prices in the HedgeStreet and cash markets. Additionally, by their nature and their underlyings, HedgeStreet’s proposed</p>	<p>Acceptable. HedgeStreet has contracted with NFA to provide specific market surveillance functions. HedgeStreet will provide the necessary data to NFA to conduct post-market surveillance.</p> <p>HedgeStreet’s rules ban any attempted manipulation of the market, and the HedgeStreet trading system will be designed with electronic surveillance features that allow it to automatically recognize unusual trading activity and alert HedgeStreet to such activity.</p>

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	<p>manipulation, price-disruption, or cash settlement problems. HedgeStreet intends to perform all cash settlement operations through its settlement bank (Union Bank of California). Therefore, HedgeStreet will be integrally involved in the settlement process, will know of any disruptions as they occur, and will be in a position to rectify any such disruptions.</p>	<p>HedgeStreet’s rules, and surveillance procedures will be adopted to monitor for violations.</p> <p>HedgeStreet’s surveillance program, as described by HedgeStreet, should minimize the potential for manipulation, distortion of prices, and/or disruption of delivery, if any.</p>
<p><b>Core Principle 5</b> <i>Position Limitations or Accountability</i> – “To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate.”</p>	<p>Application, p .22, and Appendix C to the Application (Regulatory Chart).</p> <p>HedgeStreet notes that there will be no cash market underlying the HedgeStreet contracts. Therefore, position limits and position accountability standards will not be necessary.</p>	<p>Acceptable.</p> <p>Not applicable at this time. The Division recommends that the Commission remind the Exchange that position limits or accountability standards must be established in the rules and contract specifications of HedgeStreet contracts if HedgeStreet lists contracts that do not fit the general description of underlying instruments provided in the contract market designation application.</p>
<p><b>Core Principle 6</b> <i>Emergency Authority</i> – “The board of trade shall adopt rules to provide for the exercise of emergency authority, in consultation or cooperation with the Commission, where necessary and appropriate, including the authority to – “(A) liquidate or transfer open positions in any contract; (B) suspend or curtail trading in any contract; and (C) require market participants in any contract to meet special margin requirements.”</p>	<p>Application p. 37; Rule 1.4 (Emergency Rules); Appendix C to Second Amended Application (Regulatory Chart); and Electronic Mail from HedgeStreet’s counsel dated June 20, 2002.</p>	<p>Acceptable.</p> <p>Pursuant to Rule 1.4(a), HedgeStreet’s Board of Directors by a two-thirds vote may adopt temporary emergency rules. The Board is authorized to adopt any rule that the Board deems necessary or appropriate to meet the emergency. Emergencies are defined in Rule 1.4(c) to include any activity that manipulates or attempts to manipulate the market; any actual, attempted, or threatened corner, squeeze, or undue concentration of positions; any circumstances that may materially affect the performance of the contract bundles originated by, or the contracts traded on, HedgeStreet; any action taken by the United States, any foreign government, any state or local governmental body, any other contract market or board of trade, or any other exchange,</p>

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		<p>direct impact on trading on HedgeStreet; any circumstances that may have a severe, adverse impact upon the physical functions of HedgeStreet; the bankruptcy or insolvency of any HedgeStreet member or the imposition of any injunction or other restraint by any government agency, court, or arbitrator on a HedgeStreet Member that may affect the ability of that member to perform on its contracts; any circumstances in which it appears that HedgeStreet Member or any other person has failed to perform contracts, is insolvent, or is in such financial or operational condition, or is conducting business in such a manner that such person cannot be permitted to continue in business; or any other unusual, unforeseeable, and adverse circumstance with respect to which, in the opinion of the governing board, requires immediate action and threatens or may threaten such things as the fair and orderly trading in, or the liquidation of or delivery pursuant to, contract bundles or contracts traded on HedgeStreet.</p> <p>In addition, Rule 1.4(d) provides that if it is deemed necessary to combat perceived market threats caused by an emergency, a HedgeStreet official authorized to do so may suspend trading on the Market during the duration of the emergency or take any other action that the official thinks is necessary or appropriate. The official will order an end to the action taken in response to the emergency as soon as the official determines that the emergency has sufficiently abated to permit the Market to function properly.</p> <p>Pursuant to Rule 1.4(e), HedgeStreet will make every effort practicable to notify the Commission that HedgeStreet intends to implement, modify, or terminate a temporary emergency rule pursuant to</p>

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		<p>pursuant to Rule 1.4(d) prior to the implementation, modification, or termination of the rule or action. If it is not possible to notify the Commission prior to the implementation, modification, or termination of the rule or action, HedgeStreet will notify the Commission of the implementation, modification, or termination of the rule or action at the earliest possible time, and in no event more than 24 hours after implementation, modification, or termination. In accordance with HedgeStreet Rule 1.4 (f), HedgeStreet will document its decision-making process and reasons for taking emergency action.</p> <p>HedgeStreet Rule 1.6 provides for resolution of conflicts of interest of board members in decision-making. <i>See</i> Core Principle 15, below.</p>
<p><b>Core Principle 7</b> <i>Availability of General Information</i> – “The board of trade shall make available to market authorities, market participants, and the public information concerning – (A) the terms and conditions of the contracts of the contract market; and (B) the mechanisms for executing transactions on or through the facilities of the contract market.”</p>	<p>Application, pp. 24-25.</p>	<p>Acceptable.</p> <p>HedgeStreet will publish its rules, regulations, contract specifications, and descriptions of the trade matching, clearance, and settlement systems on its website.</p>
<p><b>Core Principle 8</b> <i>Daily Publication of Trading Information</i> – “The board of trade shall make public daily information on settlement prices, volume, open interest, and opening and closing ranges for actively traded contracts on the contract market.”</p>	<p>Application, pp. 24-25.</p>	<p>Acceptable.</p> <p>Daily information on settlement prices, volume, and total open interest would be made public on the HedgeStreet website and reported to the Commission. In addition, HedgeStreet would make available to its members on a continuous basis through its website the lowest price or offer and the highest price or bid for each contract listed for trading.</p>

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<p><b>Core Principle 9 Execution of Transactions</b> – “The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions.”</p>	<p>Application dated December 19, 2003, pp. 7-21; Application, Appendix D – Licensing and Support Agreement with onExchange, dated August 7, 2003; Application, Appendix F – Hosting Agreement with USi, dated November 6, 2003; ONXBOT responses to CFTC Technical Review of Electronic Trading Systems, dated October 11, 2000; ONXBOT response to CFTC request for current technical information, dated August 18, 2003, including ONXBOT Extensible Clearing System Release Notes dated July 2003; ONXBOT ECS Administrator’s Guide.</p>	<p>Acceptable.</p> <p>The applicant’s planned use of the ONXBOT’s ECS, a system reviewed by the Commission in 2000 and found at that time to comply with the IOSCO principles, provides by reference much of the necessary information to satisfy this requirement. Commission staff has reviewed the minor system changes introduced since that earlier version and found that they do not diminish the system’s level of compliance. With regard to the hosting and operation of the system, the applicant has contracted with USi to provide those services. Commission staff conducted a review of USi in its capacity as an Application Service Provider in 2001 (during the review of EnergyClear’s application for designation as a DCO) and found that it complied with the IOSCO principles. Commission staff conducted a follow-up review of the USi facility on January 28, 2004 and validated that the previous findings were still applicable.</p> <p>On Wednesday, January 28, 2004, Commission staff conducted an onsite visit to the data center and operations areas for the purpose of observing first-hand the trading system and its supporting infrastructure, the staff and operational control facilities supporting the operation, and the physical security and environmental controls provided by the host facilities. Staff concludes that the system and hosting facility provides an open and efficient market for executing transactions.</p>
<p><b>Core Principle 10 Trade Information</b> – “The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all</p>	<p>Application, pp. 7-10 (Accessing the Exchange &amp; Trading); Rule 3.2 (Access to HedgeStreet), Rule 3.5 Order Entry) and Rule 7.1 (Monitoring the Market). Appendix C to Application (Regulatory Chart).</p>	<p>Acceptable.</p> <p>Orders submitted to purchase or redeem contract</p>

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<p>the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market.”</p>		<p>HedgeStreet and must include the following: (1) the underlying for the contract bundle; (2) the month the contract bundle will expire; and (3) the number of contract bundles the member wishes to purchase.</p> <p>Orders submitted to trade contracts are entered on the contract trading screen and must include the following: (1) order type (whether it is an order to buy or sell); (2) the underlying for the contract; (3) the month the contract will expire; (4) the price at which the member wants to buy or sell the contract; (5) the number of contracts the member wants to buy or sell; and (6) the payout criterion for the contract.</p> <p>HedgeStreet will have two types of traders:  CTI1: A user trading for his/her own account  CTI2: Any authorized user trading for the benefit of a HedgeStreet member firm’s account. The CTI information is not explicitly specified at the time of order entry. Rather, it is determined by the account number with which the trader is trading. When the account is originally set up, a field in the database is set that links the account number to the type of account it is. Therefore, the account number used for each trade determines the CTI number associated with each trade.</p> <p>HedgeStreet’s trading system will keep an electronic record of all contract bundles purchased and redeemed, all orders to trade contracts, and all executed contract trade orders. The record kept by HedgeStreet will include all of the terms identified above, as well as when the order was entered, executed and cleared, the member’s account number and the account number of all members who filled the order.</p>

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<p><b>Core Principle 11 <i>Financial Integrity of Contracts</i></b> – “The board of trade shall establish and enforce rules providing for the financial integrity of any contracts traded on the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization), and rules to ensure the financial integrity of any futures commission merchants and introducing brokers and the protection of customer funds.</p>	<p>See Designation Criterion 5, above. There will be no intermediation of contracts. Additionally, all contracts must be fully-paid up front and can not be margined. Therefore, HedgeStreet does not need to monitor minimum financial requirements of its trading members, although it will monitor trading activity for violations of trading rules. The bankruptcy or failure of a member should not affect HedgeStreet or other members of the market because there will be no margin trading and all funds necessary for settlement will be collected before a contract is opened or traded.</p>	<p>Acceptable.</p> <p>HedgeStreet has submitted a concurrent application for registration as a DCO. Member funds will be kept in customer segregation and will be invested only in investments permitted under Commission Regulation 1.25.</p>
<p><b>Core Principle 12 <i>Protection of Market Participants</i></b> – “The board of trade shall establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants.”</p>	<p>HedgeStreet will not be an intermediated market. Therefore, abuses related to intermediated trading (<i>e.g.</i>, trading ahead of customer orders or misallocating customer orders) could not take place. Consequently, HedgeStreet does not have rules prohibiting such abuses.</p> <p>Application, p.32.</p>	<p>Acceptable.</p> <p>Although the HedgeStreet market will not be intermediated, HedgeStreet has contracted with NFA to provide, among other things, Trade Practice Surveillance for HedgeStreet.</p> <p>Marketing – Although not bound by NFA Rule 2-29, HedgeStreet has proposed that it will prohibit any of its employees from disseminating any promotional material (as defined in NFA Rule 2-29(j)) regarding the exchange or HedgeStreet contracts without first providing such material to HedgeStreet’s Compliance Officer for review and approval in writing. The Compliance Officer will not otherwise assist in the preparation of any promotional material. The Compliance Officer will review all promotional material for compliance with NFA Rule 2-29 and will be responsible for keeping records of such promotional material in accordance with Commission Regulation 1.31.</p>
<p><b>Core Principle 13 <i>Dispute Resolution</i></b> – “The board</p>	<p>Chapter 8 of HedgeStreet’s Rulebook regarding</p>	<p>Acceptable. HedgeStreet has contracted with NFA to provide arbitration services.</p>



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[sic] and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries.”	Commission staff’s questions dated January 22 and February 2, 2004.	See discussion <i>infra</i> under Section V, Mandatory Arbitration for Members.
<p><b>Core Principle 14 Governance Fitness Standards</b> – “The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other persons with direct access to the facility (including any parties affiliated with any of the persons described in this paragraph).”</p>	Rules 1.2, 1.3, 2.1, and 9.2.	<p>Acceptable.</p> <p>To become a HedgeStreet member, an individual must have a bank account in the United States that the member will use to fund his or her HedgeStreet account and to receive funds from his or her account. A member must also certify that he or she resides in the United States; is of an age to enter into legally enforceable contracts; agrees to abide by HedgeStreet’s rules; and agrees to trade only for the member’s own account. An entity must generally meet the same requirements and must also certify that it is validly organized, in good standing, and authorized by its governing board, or organizing documents to trade commodities, futures, or options, and individuals authorized to trade on its behalf will trade only for the entity and will not trade as an intermediary for any other entity or person. In either case, a member must fund its account with \$500. Members will have no ownership, governance, or voting rights in HedgeStreet; neither will members act as intermediaries. HedgeStreet does not have explicit conduct related eligibility standards for members. However, HedgeStreet’s membership application does request responses to character-type questions. An applicant must state whether the applicant has ever been charged with or convicted of a criminal offense or a violation of the Act. HedgeStreet’s rules permit HedgeStreet to deny membership for any reason it deems appropriate for the protection of the market, other members, or the public. After membership is granted, a member must</p>

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		<p>change in that information.</p> <p>HedgeStreet’s rules establish fitness standards for service on the Exchange’s governing board, committees, arbitration panels, and oversight panels that consistent with Commission Rule 1.63(b). In addition, HedgeStreet will not allow any person subject to a disqualification under Rule 1.63(b) to own 10 percent or more of HedgeStreet.</p> <p>HedgeStreet represents that it will collect and monitor fitness information concerning its board members by requiring them to provide detailed disclosures, by conducting background checks, and by updating those checks annually.</p>
<p><b>Core Principle 15 <i>Conflicts of Interest</i></b> – “The board of trade shall establish and enforce rules to minimize conflicts of interest in the decision-making process of the contract market and establish a process for resolving such conflicts of interest.”</p>	<p>Rules 1.6, 1.8, 9.1, and 9.3.</p>	<p>Acceptable.</p> <p>HedgeStreet would prohibit a member of its governing board, committees, or oversight panel, from knowingly participating in the deliberation or vote on a matter if the member is the named-party in interest; has an employment, familial, or business relationship with a named-party in interest; or has a substantial financial interest in the results of any vote based upon exchange or non-exchange positions that could reasonably be affected. A member of HedgeStreet’s governing board, committees, or oversight panel must disclose any such conflicts to HedgeStreet staff before consideration of the matter. The particular board or panel will determine whether the member is subject to a conflict based upon his or her disclosures and any other source of information. A member may be allowed to participate in the deliberation of a matter if that is consistent with the public interest and the member recuses himself or herself from any vote.</p>

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		<p>HedgeStreet employees*, consultants, members of the governing board and members of HedgeStreet committees would be prohibited from trading any commodity interest traded on HedgeStreet on the basis of material, non-public information obtained through special access related to the performance of their official duties. In addition, such persons may not disclose material, non-public information obtained as a result of their employment for any purposes inconsistent with the performance of their official duties.</p> <p>* HedgeStreet Rule 9.1(a)(4) defines employee as any person hired or otherwise employed on a salaried or contract basis by a self-regulatory organization. Thus, employees of NFA conducting HedgeStreet trade practice and market surveillance would be considered employees for conflict of interest prohibition purposes.</p>
<p><b>Core Principle 16</b> <i>Composition of Boards of Mutually Owned Contract Markets</i> – “In the case of a mutually owned contract market, the board of trade shall ensure that the composition of the governing board reflects market participants.”</p>	<p>Application, pp. 34-36.</p>	<p>Acceptable.</p> <p>HedgeStreet is a for-profit, Delaware corporation and as such, is not a membership organization in the same sense as traditional mutually-owned contract markets. HedgeStreet will grant members trading privileges on the exchange; however, HedgeStreet members will not hold ownership interests in, and will not participate in the governance of, the exchange.</p>
<p><b>Core Principle 17</b> <i>Recordkeeping</i> – “The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the Commission for a period of 5 years.”</p>	<p>Application, p. 22. Rule 7.1</p>	<p>Acceptable.</p> <p>ONXBOT’s ECS will automatically store all information on the HedgeStreet system, including orders placed and all trades executed, cleared, and</p>

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		<p>HedgeStreet system and place it onto electronic storage media as defined in Commission Regulation 1.31(b)(1)(ii). That electronic storage media will be kept by USi in accordance with Regulation 1.31(b)(2). USi will also serve as the Technical Consultant with respect to the records of the HS market kept on electronic storage media and as such provide to the Commission the undertaking to furnish promptly to any representative of the CFTC or US Department of Justice such information as is deemed necessary and required by Regulation 1.31(b)(4)(i) as well as the representation required by Regulation 1.31(c) that its electronic storage system meets the requirements of Regulation 1.31(b)(1)(ii).</p> <p>HedgeStreet will be responsible for organizing and retaining all records related to its business as a contract market and derivatives clearing organization that are not generated by the HS system, such as records of investment of customer segregated funds required by Commission Regulation 1.27 and the acknowledgement from the settlement bank required by Commission Regulation 1.20(b). The records retained by HS and USi will be kept for five years, the first two in a readily accessible place, as required by Regulation 1.31(a)(1).</p>
<p><b>Core Principle 18 Antitrust Considerations</b> – “Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall endeavor to avoid – “(A) adopting any rules or taking any actions that result in any unreasonable restraints of trade; or (B) imposing any material anticompetitive burden on trading on the contract market.”</p>	<p>Application and Appendix C to the Application (Regulatory Chart).</p> <p>The Exchange has represented that it does not have conditions of access to the trading system that are non-competitive.</p>	<p>Acceptable.</p> <p>Commission Staff did not identify any antitrust issues.</p>

## **V. Noteworthy or Novel Issues**

### **A. Contract Bundles**

HedgeStreet proposes to list for trading European-style binary options, rather than the more conventional futures or option contracts listed on existing exchanges. Moreover, unlike options traded on existing boards of trade, HedgeStreet will be the sole option writer and will sell the options only through contract bundles for a fixed price of \$10.00 per bundle. Contract bundles will be the only vehicle through which new option contracts may be written.

A contract bundle will consist of one call option and one put option. Together, both options in a bundle will cover all possible outcomes. For example, suppose HedgeStreet lists a contract on a hypothetical index and the strike price is 100. A put option on this index would expire in the money if the underlying index value is less than or equal to 100, while the call option on that same index would expire in the money if the underlying index value is greater than 100. Upon expiration, suppose the index level is 102. Then the call option would be in the money and would pay a fixed amount of \$10.00, while the put option from the same bundle would expire worthless.

A member who has purchased a contract bundle may sell either or both of the component options in the secondary market through the HedgeStreet trading system. Members may also redeem complete contract bundles with HedgeStreet for \$10.00. There is no margining in the HedgeStreet system, that is, any member who purchases a contract bundle must pay the full \$10.00 for that contract bundle, and any person who purchases component option in the secondary market must pay the full price for that option.

The Commission has approved option contracts that have some features similar to the types of contracts that HedgeStreet intends to list. For example, the Commission approved the

Chicago Board of Trade (“CBOT”) to list the PCS Catastrophe Single-Event Insurance contracts, which are binary options with a fixed payout of \$10,000 (*see* the Memorandum dated December 8, 1997 to the Commission from the Division of Economic Analysis).<sup>11</sup> For those contracts, strike prices are set at various levels representing potential total insurance losses caused by a single atmospheric or earthquake event. These contracts were designed as risk management tools for the insurance industry as insurance companies can use the option to hedge risk associated with claims following a regional catastrophic event.

## **B. Mandatory Arbitration for Members**

HedgeStreet’s dispute resolution procedure – arbitration – will be mandatory for both member/member and member/HedgeStreet disputes.<sup>12</sup> This would be the second instance in which the Commission would approve a rule requiring mandatory arbitration for all members.<sup>13</sup> Prior to the enactment of the Commodity Futures Modernization Act of 2000 (“CFMA”),<sup>14</sup> Section 5a(11) of the Act required that contract markets have rules providing for voluntary arbitration facilities for customers. Post-CFMA, this requirement was removed from the Act, and replaced with Section 5(d)(13) (Core Principle 13). Core Principle 13 does not require that DCMs provide for voluntary arbitration for non-eligible contract participants, but only that

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<sup>11</sup> While similar in design, the HedgeStreet contracts are significantly smaller in size than the CBOT contracts. The smaller contract size is designed to appeal to retail traders. However, HedgeStreet’s fee schedule provides for significantly smaller per-contract fees as the transaction size increases, thus institutional traders also may benefit by trading HedgeStreet’s contracts.

<sup>12</sup> By agreeing to mandatory arbitration, HedgeStreet members would be giving up the right to the private right of action in court under Section 22(b) of the Act. Moreover, while the Commission’s reparations program is not applicable to contract markets, HedgeStreet has agreed to subject itself to the Commission’s reparations program if the Commission so requests. Staff is not recommending this at this time.

<sup>13</sup> The Commission approved a mandatory arbitration rule for ONXBOT, but unlike HedgeStreet all members of ONXBOT were required to be eligible swap participants. *See* the memorandum to the Commission from the Division of Trading and Markets dated December 21, 2000.

<sup>14</sup> Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000)

DCMs provide dispute resolution facilities as appropriate for market participants and any market intermediaries.

The contract markets that the Commission has designated post-CFMA, with the exception of ONXBOT, have all permitted intermediation. Commission Regulation 166.5, which requires that pre-dispute arbitration agreements between Commission-registered intermediaries and their customers provide for voluntary arbitration with non-eligible contract participants, was applicable to intermediaries on those markets. Accordingly, those markets had rules requiring voluntary arbitration between non-ECP customers and member firms. HedgeStreet, however, will not permit intermediation on its market.<sup>15</sup> Therefore, Commission regulation 166.5 is inapplicable because, as noted above, the regulation only applies to Commission registrants who intermediate.

The Division believes that HedgeStreet's submission, including its arbitration rules, demonstrate compliance with Core Principle 13. Mandatory arbitration is an appropriate means of resolving disputes for the HedgeStreet market because there are no intermediaries to take advantage of HedgeStreet members. Also, because there are no intermediaries, there will be no conflict between HedgeStreet's arbitration rules and Commission Regulation 166.5. Although the application guidance in Appendix B to Part 38 of the Commission's regulations relating to Core Principle 13 states that a contract market should provide contract market arbitration facilities (whether provided by the contract market or other organization) that are fair and equitable, and are voluntary for non-eligible contract participants, the application guidance is illustrative only and not a mandatory checklist. The Division believes that HedgeStreet's arbitration procedure, without the voluntariness requirement, is fair and equitable. In this regard,

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<sup>15</sup> HedgeStreet rules provide that members, whether individuals or entities, must agree not to trade on behalf of anyone but themselves.

HedgeStreet's arbitration rules require arbitration before NFA under NFA's arbitration rules. Further, HedgeStreet's arbitration rules provide that members and HedgeStreet will each bear their own arbitration expenses, and will share the cost equally for the arbitrators, unless the arbitrators determine that one of the parties acted in bad faith.

### **C. Settlement Bank and Registration as a Derivatives Clearing Organization**

HedgeStreet entered into a contract with the Union Bank of California to act as the settlement bank. The settlement bank will be responsible for accepting wire transfers of member funds, wiring funds to members upon request, and transferring fees from the member segregated account to the HedgeStreet account. All member funds will be held in a segregated funds account, but the settlement bank will not be responsible for maintaining individual member account records.

As noted above, HedgeStreet intends to list for trading fully paid-up option contracts for which HedgeStreet is the sole writer. HedgeStreet will be responsible for notifying the settlement bank of necessary movement of funds between the segregated customer account and the HedgeStreet account. In addition, HedgeStreet will be responsible for maintaining records of individual member accounts and for ordering the settlement bank to transfer member funds to private (non-HedgeStreet) member accounts upon member requests.

## **VI. Staff Analysis and Response to Comments**

### **A. Public Comments**

#### **1. Overview**

In response to its request for public comment, the Commission received five comment letters. Three commenters supported HedgeStreet's designation application and two commenters opposed or criticized some aspect of the application. The two commenters that oppose the



application are the Board of Trade of the City of Chicago (“CBOT”) and the Chicago Mercantile Exchange (“CME”). The three commenters that support the application are academics - Robert Schiller, Professor of Economics, Yale University; Ronald A. Howard, Director, Decisions and Ethics Center, Department of Management Science and Engineering, Stanford University; and Kenton K. Yee, Assistant Professor, Columbia Business School, Columbia University.

HedgeStreet’s counsel submitted a letter responding to the issues raised by the CBOT and CME.

**a. Favorable Comments**

Three commenters that support the application believe that HedgeStreet will expand the ability of individuals to hedge personal and business risks. In this respect, the commenters noted that the existing risk management tools for such risks are incomplete or inadequate.

**b. Unfavorable Comments**

The CBOT and the CME oppose the application, claiming that the application is materially incomplete and that HedgeStreet failed to demonstrate how it would meet many of the standards mandated by Congress. The comments of the CBOT and the CME are discussed in detail below.

**(1) Ownership, Governance, and Membership Issues**

**(a) Ownership and Management**

The CBOT and the CME noted that the application does not identify the management of HedgeStreet, but assumes that Pareto Partners, the parent of HedgeStreet, would be charged with operating HedgeStreet or would choose the President and executive officers of HedgeStreet, who in turn would choose the Board of Directors. The CBOT and the CME also noted that information on the management team is critical because Pareto Partners is not registered with the

Commission and thus is not accountable to the CFTC in the same manner as registered entities. The CME further noted that there is little public information available regarding Pareto's two principals and that neither has futures or financial markets experience.

Staff does not believe that these questions about HedgeStreet's ownership are an obstacle to designation. Staff notes that neither the Act nor the Commission's regulations establish any special criteria, such as experience in futures or financial markets, regarding the ownership of applicants. HedgeStreet is a Delaware corporation and, if designated, it would have an obligation to comply with all applicable provisions of the Act and the Commission's regulations, including Core Principle 14 fitness standards for persons with governing obligations or responsibilities and natural persons who directly or indirectly have greater than a ten percent ownership interest in the contract market, regardless of whether the Exchange's ultimate owners are registered with the CFTC. If HedgeStreet were to fail to comply with the core principles, its operators may be responsible under the aiding and abetting and/or controlling person provisions of the Act, sections 13(a) and 13(b), respectively.

#### **(b) Membership Fitness Standards**

The CBOT and the CME also commented that HedgeStreet rules do not adequately establish fitness standards for persons who would have direct access to the Trading Facility, in violation of Core Principle 14.<sup>16</sup> The CME noted that HedgeStreet's contention that additional

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<sup>16</sup> To become a HedgeStreet member, an individual must have a bank account in the United States that the member will use to fund his or her HedgeStreet account and to receive funds from his or her account. A member must also certify that he or she resides in the United States; is of an age to enter into legally enforceable contracts; agrees to abide by HedgeStreet's rules; and agrees to trade only for the member's own account. An entity must generally meet the same requirements and must also certify that it is validly organized, in good standing, and authorized by its governing board, or organizing documents to trade commodities, futures, or options, and individuals authorized to trade on its behalf will trade only for the entity and will not trade as an intermediary for any other entity or person. In either case, a member must fund its account with \$500.

fitness standards are not necessary because the market is not intermediated, is not recognized by the Act as a reason for dispensing with Core Principle 14. The CBOT also noted that the rules fail to provide standards for Authorized Representatives of members.

Staff believes that HedgeStreet's fitness standards are appropriate. Core Principle 14 requires members with trading privileges, but no or nominal equity in the facility, only to satisfy the minimum fitness standards to qualify as a "market participant." In the HedgeStreet model, members have trading privileges, but do not own the exchange, possess voting rights, or participate in HedgeStreet governance. To the extent that HedgeStreet members have access to the trading facility, such access is solely for the purpose of trading for their own accounts.<sup>17</sup> Moreover, HedgeStreet's membership application requests responses to some character-type questions. An applicant must state whether the applicant has ever been charged with or convicted of a criminal offense or a violation of the Act. HedgeStreet's rules permit HedgeStreet to deny membership for any reason it deems appropriate for the protection of the market, other members, or the public. After membership is granted, a member must update application information within 14 days of any change in that information. Staff believes that HedgeStreet's standards are consistent with Core Principle 14.

## **(2) NFA and Market Surveillance Issues**

### **(a) Confidentiality of the RSA with NFA**

The CBOT commented that the Commission should not continue to consider HedgeStreet's contract market application until FOIA issues are resolved regarding HedgeStreet's RSA with NFA so that the CBOT and other interested parties can make

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<sup>17</sup> HedgeStreet Rule 9.1(b) prohibits HedgeStreet's employees from trading, directly or indirectly, in any commodity interest traded on or cleared by HedgeStreet or in any related commodity interest.

meaningful comment on the RSA. In addition, because the application did not include the RSA, the CBOT and the CME noted that the HedgeStreet application is not ripe for Commission consideration. The CBOT and CME requested that the Commission not consider the HedgeStreet application until the final, executed version of the RSA is submitted and released for public comment.<sup>18</sup>

Staff does not believe that the RSA should be made publicly available because release of regulatory service agreements and materials relating to compliance and surveillance procedures could potentially enable future market participants to circumvent exchange rules.<sup>19</sup> Accordingly, staff believes that it is not necessary to release the RSA or to delay consideration of the HedgeStreet application pending public comment on that document. Moreover, HedgeStreet has provided a final, executed version of the agreement to the Commission, and staff has fully reviewed the agreement for purposes of determining its compliance with designation criteria and core principles.

**(b) Adequacy of HedgeStreet Trade Practice and Market Surveillance Program**

The CBOT and the CME both commented that HedgeStreet has not demonstrated how it would detect and prevent either market manipulation or trade practice violations to ensure fair and equitable trading. HedgeStreet has contracted with NFA to provide regulatory services to the Exchange using its Trade Practice and Market Surveillance (TPMS) program. Notably, staff

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<sup>18</sup> The Commission did not place the draft RSA on its website for public comment because it is subject to a confidentiality request by HedgeStreet on the grounds that it contains both commercial and financial information and surveillance techniques and procedures.

<sup>19</sup> For instance, these agreements often describe the criteria that regulatory service providers use to detect trading patterns that are indicative of abusive trading practices. Once particular transactions are selected on the basis of these criteria, the regulatory service provider will perform a closer analysis to determine whether some violation occurred. If market users were able to learn these selection criteria, they might be able to fashion abusive trading schemes that evade detection by the regulatory service provider.

has reviewed the NFA's TPMS program in connection with not only the HedgeStreet application, but also in connection with five previous contract market applications -- BrokerTec, LLC, Island Futures Exchange, LLC, Merchants' Exchange, onExchange Board of Trade, Inc., and U.S. Futures Exchange, LLC. Most recently, the Division of Market Oversight completed a review of NFA's TPMS in connection both with its review of the USFE's application for designation as a contract market and in its rule enforcement review of BrokerTec's trade practice and market surveillance programs.<sup>20</sup> On each of those occasions, staff found the TPMS program to be adequate.

NFA will utilize an automated system to perform market surveillance for HedgeStreet. This system will monitor, among other things, market prices and volumes as well as concentrations of large trader positions. Although HedgeStreet has represented that it would list for trading contracts that do not have underlying cash markets, NFA will monitor for each contract: (1) the basis relationship between the exchange product and the corresponding underlying market; (2) the price relationship between the exchange product and any related contracts on the same or different exchanges; and (3) the spread relationship between different months in the same exchange product. NFA's surveillance system will utilize statistical parameters for flagging anomalies in each of these three areas and place special emphasis on ensuring that the applicable basis level converges as the contract nears expirations. Additionally, as appropriate, NFA's Market Surveillance System will monitor and analyze holdings to guard against corners and squeezes. NFA will also monitor large trader positions for concentrations of ownership and potential collusive or concerted trading activity by market participants.

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<sup>20</sup> See CFTC Press Release 4847-03 (October 2, 2003) regarding DMO's rule enforcement review of BrokerTec.

With respect to trade practice surveillance, the NFA automated system will generate daily exception reports designed to identify various types of potential trading abuses and other anomalous trading activity, including, among other things, wash trading, pre-arranged trading, money passing and counter-party trade percentages. Additionally, NFA will maintain HedgeStreet trader profiles and, based upon these profiles, exception reports would alert NFA staff to deviations from a trader's normal practices. NFA will also maintain audit trail data for HedgeStreet by trade date.

Staff has reviewed the above-described NFA measures and believes that they should enable the detection and prevention of market manipulation and trade practice abuses. Based upon this assessment, as well as upon its review of the other components of the application, staff has concluded that HedgeStreet's application meets the requirements of Designation Criteria 1, 2, 3 and 6 and Core Principles 2, 4, 10, 11, 12, 13, and 14.<sup>21</sup>

**(c) NFA's Costs**

The CME was concerned that costs associated with the NFA's performance of regulatory services would be borne in part by industry participants other than HedgeStreet. That commenter sought an assurance that the NFA's costs for performing functions under the RSA would not be subsidized in any way by existing exchanges.

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<sup>21</sup> Staff notes that the CBOT's and the CME's respective comments on this point seemed to be premised on the assumption that the Commission cannot do a proper review under these Designation Criteria and Core Principles without HedgeStreet submitting a proposed contract. In fact, contract market applicants are not required to include proposed contracts in their applications. Accordingly, in reviewing a contract market application for compliance with these provisions, staff evaluates, on a non-contract specific basis, the systems and procedures that the applicant and/or its regulatory service provider will use to detect and prevent manipulation and trade practice violations. Of course, even after designation, contract markets have a continuing obligation to comply with these requirements and the Commission monitors such compliance in the course of staff reviews of contracts submitted to the Commission by such markets and through periodic rule enforcement reviews.

Neither the Act nor Commission's regulations contain any provisions regarding the fees that may be charged by regulatory services providers to new contract markets. Nevertheless, staff understands that the NFA's RSA with HedgeStreet includes both fixed-fee and volume-based pricing terms. Moreover, according to NFA staff, the pricing structure is designed to ensure that NFA's other stakeholders do not subsidize the RSA. Thus, it appears that in combination these pricing terms allow the NFA to fully recover directly from HedgeStreet all costs incurred pursuant to functions performed under the RSA.

**(3) Products and Speculative Position Limits**

**(a) Ability of the Commission to Review  
HedgeStreet's Contracts Before They Are Listed**

The CBOT commented that the HedgeStreet application fails to meet Core Principle 3 and Core Principle 7 because the application does not include specifications for contracts that HedgeStreet intends to list for trading. The CBOT and the CME stated that, in the absence of contract specifications, it is not possible for HedgeStreet to demonstrate its compliance with Core Principle 3. In addition, the CBOT and the CME stated that an applicant for contract market designation is required to make information public pursuant to Designation Criterion 7 and Core Principle 7. Specifically, it was stated that Core Principle 7 requires that a DCM applicant make available to the public, among other things, the terms and conditions of its contracts.

The CBOT and the CME are correct in noting that HedgeStreet's application does not contain the terms and conditions of the contracts that it intends to list for trading. However, under the Act, as amended by the CFMA, it is not a prerequisite to designation as a contract market for an applicant to submit the terms and conditions of the contracts that it intends to list. In fact, five of the seven exchanges that have been designated as contract markets since passage

of the CFMA did not identify the contracts they intended to list while they were in an applicant status.

A major feature of the CFMA was the elimination of prescriptive rules and approval requirements for listing new products. In this regard, the CFMA established exchange self-certification procedures whereby exchanges can list new products without obtaining prior approval; exchanges only must notify the Commission one business day prior to listing the contract and include a certification that the contract complies with the requirements of the Act and Commission rules. These procedures, which provide exchanges the flexibility to list contracts quickly to meet industry needs and competitive challenges were widely supported by U.S. exchanges, including the CBOT and the CME. Exchanges have taken advantage of the new opportunities provided and have launched a record number of new products (348 new products were filed in fiscal year 2003, far surpassing the previous record of 92 new products filed in fiscal year 1996). Moreover, since certification procedures were adopted in 2000, 90 percent of the new product filings by the CBOT and the CME have been via self-certification.

With respect to contracts filed by exchanges under certification procedures, staff conducts due diligence reviews of all such new contract filings to ensure that listed contracts comply with all applicable statutory requirements and Commission rules and policies. These reviews address Core Principle 3, which provides that DCMs list contracts that are not readily susceptible to manipulation, and Core Principle 5, which requires DCMs to adopt speculative limits or position accountability where necessary and appropriate to reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month. If deficiencies are found, the Commission initiates discussions with the contract market to address



the issues identified, and may, if no resolution is forthcoming, initiate proceedings under the Act to change the contract market's rules or adopt speculative limits.

In addition, once contracts are listed for trading, the Commission's surveillance staff closely monitors trading activity in order to detect and prevent market manipulation and other forms of market abuse. Surveillance staff keeps in close contact with the exchanges when problems arise. The exchanges have a self-regulatory obligation to take appropriate action to address market problems including the threat of manipulation. In the event an exchange is unable to take appropriate action, the Commission has the authority to take actions to address market problems, including shutting down a market.

With respect to the concern that HedgeStreet will not make available to the public the terms and conditions of its contracts, HedgeStreet states in its application that its rules, contract specifications, including the terms and conditions of all contracts, and descriptions of the trade matching, clearance, and settlement systems will be posted on the Exchange's website. Staff views those representations as sufficient to demonstrate compliance with Designation Criterion 7 and Core Principle 7.<sup>22</sup> In this regard, staff disagrees with the CBOT's assertion that applicants for designation are required by Designation Criterion 7, prior to designation as a contract market, to publish the terms and conditions of the contracts they intend to offer. Staff believes that, prior to designation, the designation criteria are intended to address a board of trade's *capacity* to perform certain functions, rather than imposing affirmative obligations. To read the designation criteria otherwise would require a board of trade to perform self-regulatory functions before any Commission approval or authorization to do so, thus rendering the designation process meaningless. Similarly, staff reads Core Principle 7 to require DCMs to make rules public following their approval by the Commission or their certification to the Commission.

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<sup>22</sup> See Commission Rule 40.8.

## **(b) Amendments to Contract Terms and Conditions**

The CME noted that HedgeStreet rules fail to provide any standards regarding amendments to contract terms and conditions or with respect to delaying settlement until an outcome is clear to HedgeStreet. The CME suggests that procedures be adopted by HedgeStreet to ensure that any adjustments do not favor one group over another. *See* Commission Rule 40.8.

Staff notes that HedgeStreet would be required to provide to the Commission, pursuant to Section 5c(c) of the Act and Part 40 of the Commission's rules, any amendments to contract terms and conditions. In its review of any rule amendment, Commission staff evaluates whether the amendment would affect the value of existing positions. If the amendment would affect the value of existing positions or adversely affect a particular group, then Staff would work with HedgeStreet to address the situation and, if appropriate, take whatever action is necessary to protect market participants.<sup>23</sup>

## **(c) Speculative Position Limits**

The CME commented that HedgeStreet proposes in its application to operate without speculative position limits. As noted above, HedgeStreet's application does not identify the terms and conditions of the contracts that it intends to list for trading, as this is not a prerequisite to designation as a contract market. HedgeStreet stated that it intends initially to list for trading contracts on underlying commodities for which there are no cash market.

It is noted that, for contracts filed under certification procedures, the staff conducts due diligence reviews of all such new contract filings to ensure that listed contracts comply with all

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<sup>23</sup> See Commission Rule 40.6(b), which provides for the Commission to stay self-certified rules during the pendency of Commission proceedings for a false certification or to alter or amend the rule.

applicable statutory requirements and Commission rules and policies, including Core Principle 5, which requires DCMs to adopt speculative limits or position accountability where necessary and appropriate to reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month. Accordingly, when HedgeStreet submits its contracts, staff will evaluate whether speculative position limit or position accountability provisions should be adopted for each contract. If any inconsistencies with the Act or the Commission's rules are found, staff will initiate discussions with HedgeStreet to correct the inconsistencies, and may, if no resolution is forthcoming, initiate proceedings under the Act.<sup>24</sup>

#### **(4) Trade Execution Issue**

The CME claimed that HedgeStreet's Application fails to meet Designation Criterion 4 because the application fails to set forth any specification of the manner or operation of the trade execution facility and failed to demonstrate that the trade execution facility operates in accordance with the rules or specifications.

Staff notes that HedgeStreet Rules 3.2 through 3.12 describe the rules and operation of the electronic matching platform. In addition, HedgeStreet's planned use of the ONXBOT ECS, a system reviewed by the Commission in 2000 and found at that time to comply with the IOSCO principles, provides by reference much of the necessary information to satisfy this requirement. Commission staff has reviewed the minor system changes introduced since that earlier version and have found that they do not diminish the system's level of compliance. With regard to the hosting and operation of the system, the applicant has contracted with USinternetworking to provide those services. Commission staff conducted a review of USi in its capacity as an

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<sup>24</sup> As noted, staff recommends that the Commission remind HedgeStreet that position limits or accountability standards must be established in the rules and contract specifications of HedgeStreet contracts if HedgeStreet lists contracts that do not fit the general description of the underlying instruments provided in the contract market designation application.

Application Service Provider in 2001 (during the review of EnergyClear's application for designation as a DCO) and found that it complied with the IOSCO principles. Commission staff conducted a follow-up review of the USi facility on January 28, 2004 and validated that the previous findings were still applicable. Additionally, on January 28, 2004, Commission staff participated in a demonstration of the trade execution facility and found that it operated as described in the application and in accordance with the HedgeStreet rules. Furthermore, as is customary in the Commission's review process, a significant amount of detailed technical information is acquired, both before and after the formal application, which is proprietary in nature and is therefore not releasable to the public. HedgeStreet has been held to the same standards for detail and comprehensiveness in this regard as have all previous applicants for contract market designation.

**(5) Financial Integrity, Clearing Issues Financial Surveillance Issues**

**(a) Settlement Bank**

The CBOT and the CME noted that HedgeStreet's application failed to identify the settlement bank, the bank's relationship to Pareto Partners, the bank's capacity and procedures to conduct settlements, and whether the bank has regulatory approval to engage in this activity. Appendix G to HedgeStreet's application consists of two letters from the Union Bank of California that describe the banking services to be provided as HedgeStreet's settlement bank. These services include maintaining HedgeStreet's proprietary and customer segregated accounts and providing for transfers of funds between HedgeStreet and its members. According to its website, Union Bank of California is one of the 35 largest banks in the U.S. and is a full-service commercial bank with branches in the U.S. west coast and overseas. The staff has not found any information indicating that Union Bank of California would be required to obtain and additional

regulatory approval from any government agency to permit it to conduct settlements for transactions conducted on HedgeStreet.

**(b) Adequacy of Clearing Operations**

The CBOT and CME questioned how HedgeStreet would operate its DCO. Staff notes that HedgeStreet will use ONXBOT's ECS for trading and clearing. The Commission previously reviewed this software system in connection with its approval of ONXBOT's application for designation as a contract market. Moreover, USi will operate HedgeStreet's trading and clearing systems using the same technology that supports EnergyClear, a currently registered DCO.

**(6) Failure to Provide the Public an Adequate Opportunity to Comment**

The CBOT and the CME assert that they and other interested parties have not been provided with adequate documentation to critically analyze and constructively comment on the application. They further contend that consideration of the application should be deferred until additional information concerning the application is made publicly available and an opportunity to comment thereon has been provided.

Staff believes that the documents posted on the website provided interested members of the public with an adequate and reasonable opportunity to comment. In this regard, the Commission posted portions of HedgeStreet's application on its website as part of its voluntary policy of posting exchange submissions and applications in order to provide the public with information on the industry.<sup>25</sup> There is no requirement in the Act or the Administrative Procedure Act that the Commission post exchange submissions and applications or seek public

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<sup>25</sup> See August 4, 2003, letter from Jean A. Webb, Secretary of the Commission, to all exchange presidents apprising them of this new policy.

comment thereon.<sup>26</sup> In these circumstances, staff believes that the Commission has the discretion to determine which documents it will post on the website.

Nevertheless, having solicited public comment on the application, staff has not identified any issues that it believes warrant seeking additional comment from the public. Moreover, CBOT or CME cannot explain how their complaints regarding lack of access to confidential materials establish a legal remedy in the form of denial of the application, rather than a remedy through the Freedom of Information Act, 5 U.S.C. § 552. The CBOT, the CME, and other interested members of the public have been provided with information concerning the Exchange's rules and intended operations and an opportunity to comment on all issues as to which staff believes public comment could be helpful to the Commission's consideration of the application.

## **VII. HedgeStreet Undertakings**

In connection with its application, the Commission has received a voluntary undertaking from HedgeStreet. Pursuant to its undertaking, HedgeStreet has made a commitment to the Commission that HedgeStreet and any official, agent or other person acting on behalf of HedgeStreet shall not engage in fraudulent conduct. Specifically, pursuant to its undertaking, neither HedgeStreet nor any official, agent or other person acting on behalf of HedgeStreet shall: (a) cheat or defraud or attempt to cheat or defraud any person; (b) willfully make or cause to be made to any person any false report or statement or cause to be entered for any person any false record; or (c) willfully deceive or attempt to deceive any person by any means whatsoever.

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<sup>26</sup> The Commission's consideration of an application for a contract market designation is an informal licensing proceeding (*see* 5 U.S.C. § 551) and is not, under the Commodity Exchange Act, its rules, or other applicable law, subject to formal on-the-record procedures.

Staff recommends that the Commission accept HedgeStreet's undertaking. In this regard, HedgeStreet's structure and intended manner of operation is qualitatively different from more traditional exchanges. HedgeStreet will not have any intermediaries; rather it will have members who interact directly with the trading facility. More traditional markets have been intermediated markets in which the intermediaries conduct most customer solicitations. Since HedgeStreet is nonintermediated, any solicitation that occurs will be by HedgeStreet. In these circumstances, to ensure that HedgeStreet customers receive a similar level of protection against fraudulent conduct, including fraudulent solicitation, as customers of more traditional exchanges, staff believes that it is appropriate for HedgeStreet to undertake not to commit fraud and for the Commission to incorporate this undertaking in its Order of Designation.

The Commission has clear legal authority to impose conditions in its order approving HedgeStreet's application for contract market designation.<sup>27</sup> In this regard, the Commission may also accept voluntary undertakings from applicants and make them binding conditions in an order of designation. The Commission also has legal authority to consider undertakings that are offered in its consideration of a contract market designation application, and it may refuse to accept any undertakings so offered. For the undertakings to be legally enforceable and binding on HedgeStreet, they must be included in the Commission order approving HedgeStreet's contract market designation application. These specific conditions and undertakings, which are set forth in the Commission's Order of Designation, will thus be enforceable under Section 6(b)

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<sup>27</sup> The Commission's regulations provide for designation of contract markets upon conditions as determined by Commission order. *See* Commission Regulation 38.3(a)(1), 17 C.F.R. § 38.3(a)(1). Moreover, the Commission has a longstanding practice to condition contract market designation approvals. *See, e.g.*, Order of Conditional Designation In the Matter of the Application of Nasdaq LIFFE, LLC Futures Exchange for Designation as a Contract Market (Aug. 21, 2001); Order of Initial Designation In the Matter of the Application of FutureCom, LTD, for Designation as a Contract Market in Cash-Settled Live Cattle Futures Contracts (Mar. 13, 2000).

of the Act, 7 U.S.C. § 8(b),<sup>28</sup> which provides for revocation of designation in the case of a DCM which violates an order of the Commission.<sup>29</sup>

### **VIII. Consideration of Costs and Benefits under Section 15(a) of the Act**

Section 15(a)(1) of the Act, which was adopted as part of the CFMA, provides that the Commission shall consider the costs and benefits of its action before promulgating a rule or issuing an order. Section 15(a)(3), however, provides for three separate exceptions from this requirement. Included among those exceptions are Commission actions that are part of an adjudicatory process and Commission actions that “are a finding of fact regarding compliance with a requirement of the Commission.”<sup>30</sup>

Staff believes that an order issued in a contract market designation proceeding is not an order for which the Commission is required to consider the costs and benefits of its action under Section 15(a)(1). Unlike general regulations and certain orders, the Commission has little discretion when it considers and disposes of an application for contract market designation. Section 6 of the Act governs the designation procedure and provides that an applicant for contract market designation “shall make application to the Commission . . . and accompany the same with a showing that it complies with the conditions set forth in [the] Act, and with a sufficient assurance that it will continue to comply with the requirements of [the] Act.” Section 6 further provides that the Commission “shall approve or deny” the application within 180 days

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<sup>28</sup> Section 6(b) of the Act authorizes the Commission to suspend or revoke the designation or registration of any contract market upon a showing, in particular, that the entity “is violating or has violated any of the provisions of this Act or any of the rules, regulations, or orders of the Commission thereunder.” 7 U.S.C. § 8 (b).

<sup>29</sup> Moreover, Section 5e of the Act, 7 U.S.C. § 7b, authorizes the Commission to suspend for up to 180 days or revoke the designation of any registered entity, as defined in Section 1a(29) of the Act, for violating among other things any order of the Commission.

<sup>30</sup> The third and final exception from the requirement that the Commission consider the costs and benefits of its actions are emergency actions.



of the filing of the application. Thus, if the Commission finds that the applicant meets the requirements of the Act, it is required to grant designation. Section 6 does not permit the Commission to deny an application due to the actual or perceived costs of approving the application.

Furthermore, staff notes that the Commission is not required to approve a contract market designation application by the issuance of an order and that it has not always done so. Moreover, under the Commission's fast track procedures, an applicant whose filing is complete and meets all of the statutory and regulatory requirements for approval could be deemed designated as a contract market 60 days after Commission receipt of the application - without the issuance of any order or other written statement.

Staff believes that it is appropriate to view orders issued in contract market designation proceedings under Section 6 as actions that result from "a finding of fact regarding compliance with a requirement of the Commission" and, thus, not requiring a consideration of costs and benefits under Section 15. In this regard, Section 6 requires an applicant to demonstrate that it *complies* with and will continue to *comply* with the requirements of the Act. If one were to read the exception for actions involving a finding of compliance as limited to more traditional findings of fact regarding compliance, the exception would be rendered meaningless as any such action would be encompassed by the separate exception for actions that are part of an adjudicatory proceeding.

Nevertheless, staff has considered the costs and benefits of designating HedgeStreet as a contract market in light of the five broad areas of market and public concern identified in Section 15(a): protection of market participants and the public; efficiency, competitiveness, and financial integrity of futures markets; price discovery; sound risk management practices; and

other public interest considerations.<sup>31</sup> Staff's considerations address the designation of a new contract market in general and the designation of HedgeStreet in particular.

The designation of a new entity as a contract market has the unambiguous effect of promoting competition and efficiencies in the trading of futures and option contracts. Key features of the CFMA were the elimination of prescriptive regulations and approval requirements to allow exchanges more flexibility in meeting their market and financial integrity obligations and the corresponding removal of barriers to entry to encourage competition among exchanges. Effective competition serves as a driving force in ensuring that exchanges continue to meet industry risk management and price discovery needs, by developing new or improved products, trading systems, etc. As long as each exchange complies with the designation criteria and core principles, the entry of a new exchange enhances competition and fosters efficiencies. In a market economy, such competition provides widespread benefits – to the industries utilizing futures and options, which receive superior risk management and pricing tools; to intermediaries and traders in the form of lower fees or superior execution; and to the U.S. and world economies as a result of lower prices and greater transparency.

As noted above, in designating an applicant as a contract market, the Commission must find that the applicant complies with all the requirements set forth in Section 5 of the Act. These requirements were adopted to ensure that market participants and the public are protected.

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<sup>31</sup> By its terms, Section 15(a) does not require the Commission to quantify the costs and benefits of a new regulation or proposed order or to determine whether the benefits of the proposed regulation or order outweigh its costs. Rather, Section 15(a) simply requires the Commission to “consider the costs and benefits” of its action. Section 15(a) further specifies that costs and benefits shall be evaluated in light of five broad areas of market and public concern: protection of market participants and the public; efficiency, competitiveness, and financial integrity of futures markets; price discovery; sound risk management practices; and other public interest considerations. Accordingly, in acting to adopt a new rule or impose a new requirement, the Commission could in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular rule or order was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the Act.

Accordingly, the designation of a new contract market should have no negative effect on the Commission's ability to protect market participants and the public. With respect to financial integrity, each applicant must demonstrate that it has established and will enforce rules and procedures for ensuring the financial integrity of transactions, including the clearance and settlement of transactions by a DCO. Moreover, designation of a new entity should have no adverse effect on the risk management practices of the futures and options industry; in fact, the new entity may offer new or improved vehicles for the industry to manage risk.

Finally, staff has not identified any costs to the public associated with the designation of a new entity as a contract market nor any other public interest considerations that should cause the Commission to withhold designation. As in any competitive situation, a new entrant devotes resources to the development of the new marketplace. If the new entrant fails, these resources would be wasted. If the new entrant succeeds, there may be a reduction of activity at existing exchanges. This does not result in a net cost to society, but rather it represents the inevitable rearrangement of capital, labor and profits inherent in a competitive market. Congress recognized the benefits ensuing from competition since, as noted above, the Act provides that if the Commission finds that an applicant meets the requirements of the Act, the Commission is required to grant designation.

With respect to the HedgeStreet application, as discussed extensively above, staff believes that HedgeStreet has demonstrated that it meets the designation criteria, the core principles and the Commission's regulations. Staff has not identified any costs unique to the designation of HedgeStreet as a contract market, nor any other public interest considerations that have not been fully addressed above. After considering each of the factors set forth in Section

15(a) with respect to costs and benefits, staff recommends that the Commission designate HedgeStreet as a contract market.

## **IX. List of Key Supporting Documents<sup>32</sup>**

### **A. HedgeStreet Submissions**

1. December 19, 2003 HedgeStreet Contract Market Application, as amended\*
2. HedgeStreet Rulebook (Appendix A to HedgeStreet Application)
3. HedgeStreet Membership Account Application (Appendix B to HedgeStreet Application)\*
4. HedgeStreet Regulatory Chart (Appendix C to HedgeStreet Application)
5. Agreement Framework Between HedgeStreet and onExchange, Inc. (Appendix D to HedgeStreet Application)\*
6. Letter dated September 10, 2003 to Mr. Harvey Theberge from David Scheinberg of onExchange, Inc. (Appendix E to HedgeStreet Application)\*
7. Master Agreement for iMap Services between HedgeStreet and USinternetworking, Inc. (Appendix F to HedgeStreet Application)\*
8. Letters dated September 10, 2003 and September 15, 2003 to Dr. John Nafeh and Mr. Philip Schaadt of HedgeStreet from Leslie Yamaguma of Union Bank of California (Appendix G to HedgeStreet Application)\*
9. HedgeStreet Certificate of Incorporation (Appendix I to HedgeStreet Application)\*
10. Regulatory Services Agreement between HedgeStreet and National Futures Association (submitted February 3, 2003)\*
11. HedgeStreet Contract Market Application dated September 22, 2003\*
12. onExchange Agreement, Redacted (submitted September 25, 2003)\*
13. Responses to CFTC Staff Questions (submitted October 7, 2003)\*
14. Responses to CFTC Staff Questions (submitted October 20, 2003)
15. HedgeStreet Request for a Stay in the Statutory Review Period (submitted October 24, 2003)
16. HedgeStreet Request for a Stay in the Statutory Review Period (submitted October 31, 2003)\*
17. Responses to CFTC Staff Questions (submitted November 5, 2003)\*
18. Responses to CFTC Staff Questions (submitted November 14, 2003)\*
19. Responses to CFTC Staff Questions (submitted November 17, 2003)\*
20. Responses to CFTC Staff Questions (submitted November 19, 2003)\*
21. Responses to CFTC Staff Questions (submitted December 5, 2003)\*
22. Clarification on NFA-HedgeStreet negotiations (submitted December 12, 2003)\*
23. Responses to CFTC Staff Questions (submitted January 22, 2003)\*
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25. Responses to CFTC Staff Questions (submitted February 2, 2003)\*

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<sup>32</sup> These and other supporting documents are before the Commission for its review. Documents on this list marked with an asterisk (\*) are subject to a petition for confidential treatment under FOIA.

26. Responses to CFTC Staff Questions (submitted February 3, 2003)\*
27. Responses to CFTC Staff Questions (submitted February 4, 2003)\*
28. Response to CFTC Staff Question (submitted February 5, 2004)\*
29. Response to CFTC Staff Question (submitted February 10, 2004)

**B. National Futures Association Submission**

1. HedgeStreet Responses to NFA Staff Questions dated December 2, 2003

**C. USinternetworking Submission**

1. Response to Staff Question dated February 6, 2004\*

**D. Comment Letters**

1. CBOT Letter to the Commission dated October 13, 2003
2. CME Letter to the Commission dated October 14, 2003
3. HedgeStreet Letter to the Commission dated October 16, 2003
4. Ronald A. Howard Letter to the Commission dated October 20, 2003
5. Robert Schiller Letter to the Commission dated October 20, 2003
6. Kenton K. Yee, JD PhD Letter to the Commission dated October 21, 2003