



ASIC

Australian Securities & Investments Commission

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Chicago Mercantile Exchange Inc

July 2005



ASIC

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Annual assessment (s794C) report

**Chicago Mercantile Exchange Inc.
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Executive summary

This report is an assessment of compliance by Chicago Mercantile Exchange Inc. (CME) with its obligations under s792A(c) of the *Corporations Act 2001* (the Act). CME is licensed to operate the financial market that is an electronic trading system known as Globex® in this jurisdiction. CME is regulated in this jurisdiction by ASIC under Part 7.2 of the Act. However, the principal place of business of CME is located in the United States of America (USA), from where Globex® is operated, and the market is regulated under the regulatory regime of the USA.

Section 794C of the Act requires the Australian Securities & Investments Commission (ASIC) to assess how well a licensed market operator is complying with its obligations as the holder of a market licence and, in particular, whether a market operator has adequate arrangements for supervising the market it operates. This is our first assessment of CME.

Compliance by CME with statutory obligations

As a result of our assessment of CME, ASIC is satisfied that CME has and continues to have adequate arrangements for supervising its market. This assessment is based on the supervisory arrangements as described in section 2.1 of this report and taking into account the nature of the market and its participants.

Observations and recommendations

With regard to some other obligations, specifically the requirement to lodge certain documents and information with ASIC in a timely manner and with adequate information, we note that during 2004 we believe that CME had not made itself fully aware of each of its new obligations as a market licensee.

ASIC and CME engaged in detailed communication to clarify CME's responsibilities and our expectations of Australian market licensees located in another jurisdiction.

With more than a full year as a market licensee, CME has advised ASIC that its reporting obligations have become part of its overall compliance monitoring program. We note that CME has lodged some of its recent reports and notifications in compliance with its obligations.

Section 1: Background

1.1 CME and the market

CME was granted an Australian market licence on 23 December 2003. The licence permits CME to operate its market, Globex® in this jurisdiction. ASIC is responsible for regulating the market in this jurisdiction under Part 7.2 of the Act.

CME is a designated contract market in the USA for the trading of futures and options on futures contracts. Electronic trading on CME commenced in 1992 and the Globex® electronic trading platform runs in parallel to CME's "open outcry" trading floor as well as providing after hours trading capability. The Globex® automated order entry facility includes order routing, order management and trade matching technology.

Users enter orders via front-end trading software, which routes the orders directly to the centralised order book. Orders may be entered for any contract, month or strategy listed on the platform at any time from the start of the pre-opening period until the market closes. The Globex® matching engine consists of a pre-defined set of matching rules (algorithms) that facilitate trade execution.

CME requires all Australian participants to hold an Australian financial services licence that permits them to trade in products of the same kind as those that can be dealt with on the market unless the participant is exempt under Australian law from the requirement to hold such a licence in relation to participation in the market. At the time of our assessment there were no Australian participants connected to Globex®. However, CME has announced that an Australian participant is expected to begin trading through Globex® during the week of July 11, 2005.

Regulation of CME in the USA

CME is currently registered with the Commodity Futures Trading Commission (CFTC) as a designated contract market and as a derivative clearing organisation. This constitutes CME's authorisation to operate its market and clear transactions. CME is a self-regulatory organisation with front-line supervisory responsibility for its markets, however this is augmented by CFTC oversight.

CME is governed by a combination of the by-laws, rules and regulations contained in the CME Rulebook and regulated by the legislation and related regulations as administered by the CFTC. The purpose of that regulatory regime is to serve the public interest by protecting investors, ensure market integrity and to avoid systemic risk.

Regulation of CME in Australia

CME's Australian market licence was granted under s795B(2) of the Act, which lists criteria for granting a market licence to an overseas-based operator. These criteria include a requirement that the regulatory regime of the home country is sufficiently equivalent in terms of investor protection and market integrity outcomes to the Australian regulatory regime. Consequently, our approach to regulating overseas-based markets places a degree of reliance on the regulatory regime imposed by the home regulator of that market.

While CME is required to comply with each of its obligations under the Act and any conditions imposed by its licence, ASIC necessarily relies to some extent on the regulation of CME and CME's Globex® platform undertaken by the CFTC to be satisfied that CME is complying with its Australian obligations.

In this regard we note that ASIC and the CFTC are signatories to two memoranda of understanding concerning consultation, cooperation and exchange of information.

1.2 The assessment process

ASIC must undertake an annual assessment under s794C(2) of the Act to determine the extent of compliance by a licensee with its obligations at s792A(c) of the Act relating to supervision of the market.

Section 794C(1) of the Act permits ASIC to extend the scope of its annual assessment to licensee compliance with any or all of its obligations under Chapter 7 of the Act. We have extended the scope of this report to include some matters of compliance noted during the assessment period.

How we conducted this assessment

Our assessment of CME was based on information that ASIC had at hand, and information obtained from CME and from the CFTC. Specifically, in conducting our assessment under s794C, we:

- analysed information received from and about CME in the ordinary course of our dealings with CME;
- reviewed CME's most recent annual report and CME's annual regulatory reports under s792F of the Act;
- sought additional information and commentary from CME and the CFTC for the purpose of this assessment; and
- considered how well CME might comply with its obligations in the future.

Section 2: Observations and Recommendations

After making our assessment, ASIC is satisfied that CME has and will continue to comply with its obligations under s792A(c) of the Act. Section 2.1 addresses our requirement under s794C(2) to assess the adequacy of CME's supervisory arrangements. Section 2.2 discusses other areas of compliance that were noted during the assessment period.

2.1 Supervision of the market

Our conclusion is based on the following observations drawn from information gathered during the assessment process:

1. In its application for an Australian market licence, CME described a number of arrangements for supervising its market. These arrangements were assessed as being adequate to satisfy the requirement under s792A at the time of, and as evidenced by, the granting of CME's market licence.
2. CME confirmed to ASIC that the arrangements for supervising the market had not changed in any material way from the description provided in its application for a market licence.
3. CFTC confirmed that it had no concerns with CME's supervision of Globex®.
4. During our assessment, nothing came to our attention to suggest that the supervisory arrangements were not operating properly.

Brief descriptions of the supervisory arrangements follow.

Handling conflicts of interests

Paragraph 792A(c)(i) of the Act requires that CME have adequate arrangements for handling conflicts between its commercial interests and the need for it to ensure that the market operates in a fair, orderly and transparent way.

To ensure that the commercial interests of the CME do not compromise the integrity of its markets, the CME Rules provide that any relevant person or entity must disclose and may be required to abstain from the deliberations of a committee (ie, the CME Board or a body authorised to issue disciplinary charges) if that person or entity is identified as a subject of any matter being considered by a committee, or has, or may have, a financial interest in the outcome of the matter.

Monitoring the conduct of participants

Paragraph 792A(c)(ii) of the Act requires that CME have adequate arrangements for monitoring the conduct of participants on or in relation to the market.

The self-regulatory framework of CME includes procedures to recognise and, to the extent possible, prevent disruptions of CME markets. CME, through its Market Surveillance Department within the Division of Market Regulation, is responsible for ensuring that participants in the marketplace do not interfere with the normal price discovery mechanism. The obligation to deter abusive practices is fulfilled through an ongoing program of market observation coupled with an active enforcement process that is continually reviewed for timeliness and effectiveness.

The Division of Market Regulation is responsible for detecting, investigating and prosecuting trade practice violations. This Division's compliance systems provide data processing support for CME's investigative activities. Regulatory program investigators are responsible for monitoring compliance with specific CME rules regarding dual trading, trading within broker associations, top step trading restrictions and out-trade assignments. Data analysts conduct audit trail reviews of trading records and clearing submissions to determine whether required information is being properly recorded and accurately reported to CME. CME's investigators analyse daily exception reports and conduct analysis of cleared trades and other data to detect potential trading violations with respect to Globex® trading. Where a trading activity is identified which may violate a CME rule, the matter is referred for further investigation. Once an investigation is concluded the matter may be referred to a disciplinary committee.

Enforcing compliance with the market's operating rules

Paragraph 792A(c)(iii) of the Act requires that CME have adequate arrangements for enforcing compliance with the market's operating rules.

The CME Managing Director - Regulatory Affairs has responsibility for enforcing the CME Rules and utilises the facilities of the Division of Market Regulation to conduct investigations of rule violations and market conditions. The Managing Director - Regulatory Affairs has the authority to inspect the books and records of all participants and may require any participant to appear before him or her and produce their books and records and to answer questions regarding possible violations of CME Rules.

The CME Division of Market Regulation assists the Managing Director - Regulatory Affairs by conducting trade practice reviews, investigations, data assurance audits and large trade surveillance. This Division also administers the member and customer arbitration forums and acts as prosecutor when disciplinary hearings are conducted against CME

members. The CME Probable Cause Committee receives and reviews investigation reports from the Division of Market Regulation. This committee is empowered to determine whether there is a reasonable basis to charge a rule violation and is responsible for the preparation of charges.

The CME Business Conduct Committee considers possible violations of the CME's Rules relating to trading practices, sales practices, trading conduct and ethics of participants and others and has the power to conduct investigations and hearings. If a CME member is found guilty of a rule violation, the penalties that can be imposed by CME under the Rules include fines of up to USD\$1,000,000, suspension or expulsion.

2.2 Other observations

Obligations to notify ASIC

CME has a number of ongoing obligations under the Act, including when and in what circumstances it must lodge documents or notify ASIC of specified events. In some instances, outlined below, ASIC believes CME was not completely familiar with its reporting obligations. We raised our concerns with CME and provided them with greater detail of our expectations.

To allay our concerns, CME has advised that in future it will meet its reporting obligations in a timely and detailed manner.

Reporting obligations

Annual regulatory report

CME lodged its s792F annual regulatory report for the period 1 January 2004 to 31 December 2004 with ASIC on 23 March 2005. ASIC noted that the content of the report, notwithstanding that CME had yet to connect any Australian participants to Globex®, did not include sufficient information to satisfy the requirements of the relevant regulations. ASIC provided similar feedback to CME regarding its annual report for the 2003 reporting period.

CME has undertaken to ensure that all future regulatory reports include information and statements as prescribed by regulations or requested by ASIC.

Reports required by licence

Section 10 of CME's market licence requires CME to lodge with ASIC a report each six months that provides information about the volumes traded on Globex® in Australia and globally, and lists all Australian participants. As CME had not yet connected any Australian participants to Globex®, provision of such information has not been necessary. As

noted above CME have advised ASIC that an Australian participant is expected to begin trading through Globex® during the week of July 11, 2005.

Operating rule changes

Section 793D(3) of the Act requires CME to provide ASIC with a written notice if a change is made to the rules of the market as soon as practicable after the change is made. ASIC acknowledges that CME has provided notices in relation to rule changes in a timely manner and with sufficient information to satisfy CME's obligation.

Change in holding or voting power

Pursuant to section 792B(5) of the Act, CME provided notice to ASIC of changes in senior office bearers at CME. ASIC informed CME that the information provided did not include some of the information prescribed by the relevant regulations. CME subsequently provided ASIC with supplementary information to satisfy the regulatory requirements.

ASIC believes that CME is now fully aware of the information required to be included in such notifications and is confident that future notices will include all the necessary information.