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Division of
Market Oversight

November 30, 2005

INFORMATIONAL MEMORANDUM

TO: The Commission

FROM: The Division of Market Oversight

SUBJECT: Amendments to Chicago Board of Trade rule 425.01 regarding the adoption of spot-month position limits for the U.S. Treasury Bond, 10-Year U.S. Treasury Note, 5-Year U.S. Treasury Note and 2-Year U.S. Treasury Note futures contracts, submitted pursuant to certification procedures of Section 5c(c)(1) of the Commodity Exchange Act.

CONCLUSION AND RECOMMENDATION: The amendments appear neither to violate nor to be inconsistent with the Act or the Commission's regulations or policies. Therefore, the Chicago Board of Trade's certification appears to meet the requirements of Section 5c(c)(1) of the Commodity Exchange Act, and no action by the Commission is recommended. Absent objection prior to the close of business on December 2, 2005, the Division plans to approve the amendments pursuant to the authority delegated in Commission Rule 40.7(b)(5).

CONCURRING: Office of the General Counsel

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INTRODUCTION

In correspondence dated June 28, 2005, the Chicago Board of Trade (CBOT or Exchange) filed with the Commission, pursuant to the self-certification procedures of Section 5c(c)(1) of the Commodity Exchange Act (CEA or Act) and Commission Regulation 40.6, amendments to CBOT rule 425.01 to adopt spot-month position limits for the U.S. Treasury Bond, 10-Year U.S. Treasury Note, 5-Year U.S. Treasury Note and 2-Year U.S. Treasury Note

futures contracts (collectively Treasury futures contracts).[1] Specifically, the CBOT adopted a spot-month position limit of 25,000 U.S. Treasury Bond futures contracts, 50,000 10-Year U.S. Treasury Note futures contracts, 35,000 5-Year U.S. Treasury Note futures contracts and 25,000 2-Year U.S. Treasury Note futures contracts. Each spot-month position limit will be in effect during the last ten trading days of an expiring futures contract month. In addition, the amended rules provide for no exemptions from the position limits, including exemptions for bona fide hedge positions. The new limits were put into effect on June 29, 2005 and are applicable to the December 2005 contract months and to all subsequent contract months. Prior to adoption of the amendments, the subject contracts were subject to position accountability.

ANALYSIS AND CONCLUSION

Compliance with the Act and Commission Regulations

The Division of Market Oversight (Division or DMO) has reviewed the CBOT's submission to ascertain compliance with the Act and Commission regulations. The CBOT, as a designated contract market (DCM), has a statutory self-regulatory responsibility to ensure the integrity of its markets. To that end, the CBOT has stated that position limits are necessary to reduce the probability that a single party could cause a price distortion in the expiring subject futures contracts.

For the reasons discussed below, the Division has concluded that the CBOT action to establish spot month position limits does not violate the Act or Commission regulations. In that regard, for designated contract markets, the applicable statutory requirements with respect to the subject filing are found in core principles 3, 4, and 5.

Core Principle 3 states that such DCMs "shall list on the contract market only contracts that are not readily susceptible to manipulation." The Commission's acceptable practices for Core Principle 3 are set forth in Guideline No. 1, which specifies that, for physical delivery contracts, "the terms and conditions, as a whole, [should] result in a deliverable supply such that the contract will not be conducive to price manipulation or distortion and that the deliverable supply reasonably can be expected to be available to short traders and salable by long traders at

[1] In accordance with Section 2(a)(9)(B)(i) of the Act, on June 30, 2005, Division staff forwarded the CBOT's certification filing to the Department of the Treasury (Treasury) and the Board of Governors of the Federal Reserve System via electronic mail. In addition, in accordance with Section 5c(c)(1) of the Act, the CBOT filed the amendments with the Secretary of the Treasury. The Commission did not receive from either agency comments regarding the CBOT's certification filing.

its market value in normal cash marketing channels." Generally, in assessing a contract's susceptibility to manipulation, for contracts where the size of the commodity underlying the future is limited, staff considers, among other things, whether the DCM has specified a spot-month limit and whether the limit is set at a level that would constrain a trader's ability to exercise market power.

A combination of market factors and events have led the CBOT to adopt the subject position limits in order to limit a trader's ability to exercise market power to manipulate or distort the market. These market factors and events include: 1) the current low interest rate and flat yield curve environment that has encouraged delivery of bonds and notes with short durations and short remaining times to maturity; 2) the doubling of the proportion of open interest in the Treasury futures contracts relative to the underlying cash market in the last two years; 3) the increased incidence of fails in the cash market and in the repo market for Treasury securities which has raised concerns that traders holding short positions will not be able to obtain and deliver the cheapest to deliver (CTD) securities; and 4) the congestion issues that have occurred during three recent CBOT Treasury futures expirations.

In view of the above cited market factors and events, it is reasonable to conclude that the CBOT's adoption of spot-month position limits represents an appropriate self-regulatory action to address bona fide concerns about manipulation and congestion, and, therefore, that the rule amendment complies with the requirements of Core Principle 3. In that regard, the subject position limits are specifically designed to restrict a trader's ability to exercise market power by limiting the maximum size of a position that can be held during the last ten trading days of the expiring contract month. Moreover, position limits are a commonly used tool to address manipulation concerns and to ensure that futures contracts with limited deliverable supplies are not readily susceptible to manipulation or price distortion.

Core Principle 4 requires exchanges to "monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process." The acceptable practices under Core Principle 4 state, in pertinent part, that the board of trade should collect and evaluate various market data in order to make an appropriate regulatory response to potential market disruptions or abusive practices. To fulfill their oversight responsibilities, many DCMs have adopted spot-month speculative position limits to address concerns about manipulation and inadequate deliverable supplies. As discussed below, recent pricing anomalies in its Treasury

futures contracts have led the CBOT to adopt the subject position limits. Thus, it is reasonable to conclude that the CBOT, by adopting the subject position limits, acted in a manner consistent with Core Principle 4. Furthermore, because the CBOT has the greatest stake in the commercial utility, viability and success of its Treasury futures contracts, it is in the CBOT's best interest to fulfill its responsibilities as a DCM and to protect its markets from disruption. Assuming the Act and Commission regulations are complied with, the Division does not believe a DCM should be second guessed about the actions it takes to protect its own markets from disruption.

Core Principle 5 states that DCMs shall provide for speculative position limits or position accountability where necessary and appropriate "to reduce the potential threat of market manipulation or congestion." While not specifically retained as applicable to DCMs under Commission Regulation 38.2, Commission Regulation 150.5 is included as an acceptable practice under Core Principle 5, and it states that "for physical delivery contracts, the spot month limit level must be no greater than one-quarter of the estimated spot month deliverable supply, calculated separately for each month to be listed." The table below shows that the CBOT's position limits generally comply with Commission Regulation 150.5 with respect to the deliverable supply of the CTD security.

CBOT US Treasury Futures Contract	Spot-Month Position limit (in contracts)	Deliverable Supply of CTD from March 2004- June 2005 (Range in contracts)	25 percent of deliverable supply (in contracts)
Treasury Bond	25,000	280,000-67,000	70,000-16,750 [8]
10-Year Treasury Note	50,000	240,000-200,000	60,000-50,000
5-Year Treasury Note	35,000	330,000-150,000	82,500-37,500
2-Year Treasury Note	25,000	130,000-120,000	32,500-30,000

The position limits for the subject futures contracts apply only to positions in the expiring contract month during their last ten trading days. The Commission has previously stated that it believes, consistent with its experience in conducting surveillance of other futures markets, that

[8] The U.S. Treasury Bond futures contract position limit may need to be reduced should the CTD deliverable supply fall below the equivalent of 100,000 futures contracts for the expiring contract month.

it is during the period near contract expiration that the potential for manipulation based on an extraordinarily large futures position would most likely occur.[2]

In view of the above considerations, it is reasonable to conclude that the spot-month position limits meet the requirements of Core Principle 5. In that regard, the subject position limits should provide for orderly liquidations of positions to levels that should minimize the risk of congestion and price distortion in the cash market heading into the expiration and delivery of the subject futures contracts.

Application to Existing Positions

At the time the spot-month position limits were adopted, each of the affected contracts had previously been listed for trading. The new position limits and related information, including open interest at the time the limits were announced, are shown in the table below. As the table shows, only the December 2005 10-year Treasury Note futures contract had open interest (109,702 contracts) greater than the new spot-month position limit (50,000 contracts).

CBOT U.S. Treasury Futures Contract	Spot-Month Position limit[3] (in contracts)	Principal value per contract	Notional value of a position at the limit (in billions)	Open Interest in the 12/05 future at the time of certification (in contracts)
Treasury Bond	25,000	$100,000	$2.5	14,906
10-Year Treasury Note	50,000	$100,000	$5.0	109,702
5-Year Treasury Note	35,000	$100,000	$3.5	8,783
2-Year Treasury Note	25,000	$200,000	$5.0	0

As of June 28, when the CBOT filed its self-certification, only one trader held a futures position above the new limit in an affected Treasury futures contract month. In addition the Division analyzed position data for the last six expirations of each of the four affected CBOT Treasury futures contracts to see how many traders would have had positions above the new limits. Specifically, for each expiration from March 2004 through June 2005, staff calculated the

[2] See, for example, 66 Fed. Reg. 55078, dated November 1, 2001, regarding speculative position limits on security futures products.

[3] Options on the subject Treasury futures contracts cease trading in the month prior to the delivery month of the underlying futures contract. Thus, the new position limits apply only to the expiring futures contract.

size of the CTD security in terms of the equivalent number of futures contracts.[4] Using that data, staff then determined the total open interest going into the last ten trading days and the number of traders that held positions above the new limits. For the 2-year note contract, no trader would have been over the position limit of 25,000 contracts; indeed, total open interest in that contract was rarely above 25,000 contracts during the last ten trading days of an expiring contract. For the 5-year note contract, in two contract months, there were no traders that would have been above the limit of 35,000 contracts and, in four contract months, one to three traders would have been above that level. For the 10-year note contract, in two contract months, there were no traders that would have been above the limit of 50,000 contracts and, in four contract months, only one or two traders would have been above that level. For the 30-year bond contract, in four contract months, only one trader would have been above the limit of 25,000 contracts while in two contract months, three traders would have been above that level.

The analysis above shows that the application of the position limits should not affect the vast majority of market participants and that only one trader actually had a position greater than the limits at the time of implementation. Moreover, those participants who, during the life of a contract month, amass positions larger than the subject position limits should not be materially affected if, as is the norm, they roll their positions before the last ten trading days of the expiring contract month. Further, the CBOT certified its amendment five months before the December 2005 expiration, giving market participants ample time to unwind positions in excess of the applicable position limit.

As discussed below, the Division generally has viewed position limit rules as being price neutral and not having a material affect on the value of existing positions. This is because position limit rules do not affect any of the economic characteristics that define the commodity underlying the contract and, thus, position limits should not impact the pricing basis of the contract. However, market participants noted that there was a price effect in the 10-Year U.S. Treasury Note futures contract after the CBOT announced that it was adopting position limits. In

[4] For example, if the size of the CTD 10-year note were $20 billion, and the notional value of the CBOT's 10-Year Treasury Note futures contract were $100,000, then the size of the CTD security in terms of futures contracts would be 200,000 futures contracts ($20,000,000,000/$100,000=200,000 contracts). The deliverable supply of the underlying CTD Treasury issues for six recent expirations, starting with the March 2004 expiration through the June 2005 expiration, ranged from $26 billion (130,000 contracts) to $24 billion (120,000 contracts) for the 2-Year Note contract, $33 billion (330,000 contracts) to $15 billion (150,000 contracts) for the 5-Year Note contract, $24 billion (240,000 contracts) to $20 billion (200,000 contracts) for the 10-Year Note contract, and $28 billion (280,000 contracts) to $6.7 billion (67,000 contracts) for the 30-Year Bond contract.

this regard, it appears that the market had been pricing the basket of Treasury notes instead of the CTD, because market participants believed that the CTD security would be in scarce supply. It also appears that the market began to price the CTD following the CBOT's adoption of the position limits, and therefore the effect was ameliorative, as explained on page 21. Thus, the Division has not found any reason to conclude that the Exchange's implementation plan violates the Act or Commission regulations.

Position Limit Approval

The Division has reviewed the CBOT Treasury futures position limits to determine whether the subject amendments should be approved. In that regard, paragraph (b)(9) of the Acceptable Practices for Core Principle 5 provides that, "[a] violation of contract market position limits that have been approved by the Commission is also a violation of section 4a(e) of the Act. The Commission will consider for approval all contract market position limit rules."

As discussed above, the Division has concluded that the CBOT's position limit rule amendments do not violate the Act or Commission regulations. The limits are not inconsistent with Core Principle No. 5 for a designated contract market which states that such markets shall provide for speculative position limits or position accountability where necessary and appropriate "to reduce the potential threat of market manipulation or congestion."

In view of the above, the Division believes that it is appropriate to approve the subject position limits for the purpose noted above. Accordingly, absent objection by the Commission prior to the close of business on Friday, December 2, 2005, the Division Director intends to approve, on behalf of the Commission, the subject position limits pursuant to the delegated authority of Commission Regulation 40.7(b)(5). In this regard, in a memorandum to the Commission dated October 12, 2001 concerning Commission approval of amendments to the spot-month limit for the CSCE's cocoa futures contract, the Division advised the Commission that, absent the Commission's objection, it would approve amendments to exchange speculative position limits on behalf of the Commission pursuant to Commission Regulation 40.7(b)(5). In acting to approve this CSCE amendment on October 29, 2001, the Commission did not object to the Division's plan to approve by delegated authority spot-month limits for other futures and option contracts that are consistent with the Commission's policy. A draft approval letter to the

Exchange regarding the Division's approval of the subject position limits, pursuant to the authority delegated in Commission Rule 40.7(b)(5), is attached.

BACKGROUND

Exchange Rationale

In conversations with Exchange officials at the time the submission was filed, the CBOT stated that position limits were necessary to reduce the probability that a single party could cause a price distortion in the expiring futures contract. Subsequently, in a letter dated August 10, 2005, the Exchange further noted that the position limits were needed because the available supply of the cheapest-to-deliver (CTD) bond or note likely would not be adequate to accommodate expected deliveries, due to a combination of market factors. First, the current low yield and flat yield curve environment encourages delivery of bonds and notes with short durations and short remaining times to maturity. Second, the proportion of open interest in the Treasury futures contracts relative to the underlying cash market has nearly doubled in the last two years, increasing demand for the CTD securities. Finally, the CBOT stated that the increased incidence of fails in the cash market and in the repo market has "eroded trade certainty in the Treasury market in ways that impair the ability of market participants to perform cash-futures arbitrage." Together, these factors have caused pricing of the futures contracts to become distorted because of the market perception that the CTD bond or note would not be available for shorts to deliver.

As noted above, the amended rules provide for no exemptions from the position limits, including exemptions for bona fide hedge positions. According to CBOT staff, granting hedge exemptions would undermine the ability of the position limit to reduce the probability that a single party could have a large enough position to cause a price distortion in an expiring futures contract. Moreover, according to CBOT staff, because most large traders are commercials with related cash market or other positions, it would be very easy for an entity to claim a hedge exemption and thereby justify a large futures position.

Summary of the CBOT Treasury Futures Contracts' Terms and Conditions

For each of the subject CBOT futures contracts, the par pricing basis is a notional

Treasury security of a specific maturity and a coupon rate of 6%.[5] The Treasury Bond and the 10- and 5-Year Treasury Note futures contracts have a contract size of $100,000 face value; the 2-Year Treasury Note futures contract has a contract size of $200,000 face value. The last trading day for the Treasury Bond, 10-Year Treasury Note, and 5-Year Treasury Note futures contracts is the eighth business day prior to the end of the contract month. The last trading day for the 2-Year Treasury Note futures contract is typically the last business day of the contract month. Delivery generally may be made on any business day during the contract month.[6]

Each Treasury futures contract provides for delivery of any security that falls within a specified window of eligible maturities. For example, for the 10-year Treasury note futures contract, eligible securities must have at the time of delivery a remaining time to maturity between 6.5 years and 10 years. In order to create equivalence among the various securities in the deliverable basket that have different maturities and coupon rates, the Exchange applies a conversion factor to adjust the prices of the deliverable securities to a specified notional coupon rate and term-to-maturity. Currently, the specified notional coupon rate is 6%. The further away the market is from a 6% yield environment, the less well the adjustment factors equilibrate all securities within the basket; thus, some issues are cheaper to deliver than others. Traders routinely rank all of the deliverable securities from CTD to most expensive to deliver.

History of Speculative Position Limits in CBOT Treasury Futures

The CBOT's Treasury contracts initially were approved and listed without speculative position limits. Subsequently, in 1981, the Commission adopted regulation 1.61 which required exchanges to adopt speculative position limits. In 1985, the Commission approved the CBOT's spot-month and all-months-combined speculative position limits for each of the CBOT's Treasury futures contracts. Specifically, the Commission approved speculative position limits of 10,000 contracts for the Treasury Bond futures contract, 5,000 contracts for the 10-Year

[5] On March 23, 1999, the Commission approved CBOT amendments to change the notional coupon to 6% from 8% for each of the Treasury futures contracts. Those amendments were applied to newly-listed contract months only. *See*, the memorandum to the Commission dated March 12, 1999.

[6] For the 2-Year Treasury Note futures contract, the last delivery day is the third business day following the last day of trading. For the other subject futures contracts, the last delivery day is the last business day of the contract month.

Treasury Note futures contract, and 1,000 contracts for each of the 5-Year Treasury Note and 2-Year Treasury Note futures contracts.

In 1992, the Commission approved rule amendments establishing position accountability provisions in lieu of position limits for the CBOT Treasury Bond, 10-Year Treasury Note, and 5-Year Treasury Note futures contracts. In 2004, the CBOT self-certified a rule change to adopt position accountability provisions in lieu of position limits for the 2-Year Treasury Note futures contract.

Historical Pricing of Treasury Futures

As noted, the CBOT's Treasury futures contracts allow for delivery of several securities within a specified maturity range, and traders rank the securities from CTD to most expensive to deliver. Traders expect shorts to deliver the CTD security in the basket; thus, the contracts usually price the CTD security and the futures price for an expiring contract month typically converges to the CTD security. Market factors determine which of the securities in a basket is CTD at any point in time, and market participants are able to reliably consider the CTD as the pricing basis. In fact, CTD securities have settled nearly all Treasury futures deliveries since the inception of futures trading. This has resulted in a stable and predictable basis relationship for commercials to hedge price risk, and it is believed to be a contributing factor to the growth in these markets. If a contract's pricing basis becomes unclear due to lack of certainty as to what security the futures market will be pricing at expiration, it may result in less reliable and more volatile basis relationships that could impair the hedging efficiency of the markets in the future.

Historically, Division surveillance staff, as well as staff of the other financial regulators, has viewed the applicable CTD security as the pricing basis of the Treasury futures contracts in most instances, and analyses of the futures market's performance near expiration are based on price relationships where the CTD security is considered the benchmark. In situations where the futures price deviates from the CTD benchmark, staff conducts inquiries to ascertain what factors—fundamental, technical, or illegitimate —may have caused the pricing anomaly.[7] The

[7] The Commission found price manipulation in the June 1993 10-Year Treasury Note futures contract, where a trader with a long futures position intentionally gained and maintained control over a dominant supply of the CTD notes, exacerbating the tightness of supply by increasing its position and intentionally withholding the notes from the market, thereby forcing shorts to meet their futures delivery obligations with securities that were more expensive than the CTD security. In this regard, in the Matter of Fenchurch Capital Management, LTD, (Fenchurch) Respondent, CFTC Docket No. 96-7, July 10, 1996, the Commission found that "Fenchurch attempted to

other financial regulators also generally assume convergence to the CTD and expect that such futures pricing deviations should be explained in terms of market fundamentals or commercial activity.

Recently, open interest in the Treasury futures contracts has grown significantly, with large open interest in contract months approaching expiration. Trade commentary discussed whether there would be sufficient supply of the CTD security to meet the demand for futures delivery resulting from the large open interest.[8] In some cases during the last few weeks of trading in expiring futures contracts, open interest was so large relative to the availability of the CTD security that the futures price was above its "fair value" relative to the CTD security based on standard pricing models. The trade labeled this phenomenon as a "squeeze premium"; *i.e.*, trade publications suggested that the demand for futures delivery may exceed the availability of the CTD security so that traders holding short futures positions may have to acquire a more expensive security from among those in the deliverable basket. The size of the premium was a function of the size of the anticipated demand for delivery (generally viewed as a percentage of open interest) and the difference in adjusted prices between the CTD security and the next cheapest.

In four recent expirations, notably, the December 2004 5-Year Treasury Note expiration, the March 2005 10-Year Treasury Note expiration, the June 2005 10-Year Treasury Note expiration and the September 2005 10-Year Treasury Note expiration, the Division and the Exchange heightened their surveillance efforts to address liquidation concerns. In each instance one or two traders had accumulated large long positions in the expiring futures contract and held those positions longer than is typically observed by surveillance staff. As market participants observed that the open interest in the expiring contracts was not being rolled over to the nearest deferred contract month, the market began to price a "multi-asset" delivery. Thus, because of

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manipulate and did manipulate upward the value of Fenchurch's long futures position in the June contract by attempting to corner and cornering the available supply of the cheapest-to-deliver notes on the June contract in violation of Section 6(c) and 9(a)(2) of the Act 7 U.S.C. §§ 9 and 13(a)(2)." The Commission reached a settlement with Fenchurch in which the Commission ordered Fenchurch, among other things, to cease and desist from violating the above noted provisions of the Act and pay a civil monetary penalty of $600,000.

[8] The CTD security is in demand specifically for futures delivery when its price is high (and yield is low) compared to securities with similar maturities and/or its financing rate in the repo market is much lower than that for similar securities—even to the extent that it is in such high demand to meet futures delivery obligations that owners of the CTD security may be able to finance it at near zero interest (a so-called "fails" rate).

concern that the CTD security was not going to be available to cover all deliveries, the market began to price at a premium to fair value both the futures contract and the CTD in the cash market. The problems experienced with the December 2004, March 2005 and June 2005 expirations in large part led the CBOT to adopt the subject position limits for its Treasury futures contracts, while the problems experienced with the September 2005 expiration reaffirmed the need for the CBOT to adopt the subject position limits.

COMMENTS RECEIVED AND STAFF RESPONSES

The Commission received four comment letters concerning the CBOT position limits rule amendments. Three comment letters were from (in the order received): (1) EMF Financial Products ("EMF"); (2) a market participant ("MP"); and (3) the Futures Industry Association ("FIA"), all expressing concerns about the CBOT rule amendments. The fourth comment letter was received from the CBOT responding to the issues raised in the FIA letter. The letters from EMF, the FIA and the CBOT have been posted on the Commission's website. The letter from "market participant" was not posted because it included proprietary information regarding the commenter's market positions, which the Commission is prohibited from disclosing under § 8(a)(1) of the Act.

The following discussion addresses all the comments received under eight general headings. Comments from FIA, EMF and MP are separately identified and appear under the applicable subject headings. The responses following each of the comments include both points raised by Commission staff and, where applicable, points raised in the CBOT response letter.

1. CBOT's Rationale Lack Transparency

FIA generally criticizes the CBOT's rulemaking processes for lack of transparency and the lack of opportunity for member firm input on significant rule proposals. FIA raises concerns that the CBOT's rule amendment certification fails to describe both the particular problem that the position limit was intended to correct and the market participants and government agencies that CBOT claims to have consulted. The CBOT, however, did provide an extensive description of the rationale and process involved in its decision to implement position limits in its subsequent comment letter to FIA (see sections of the letter entitled: "The Rationale for Position

Limits: Measured Response to Market Concern" and "Position Limits: Structure, Function and Operation").

FIA further states that the CBOT cannot properly adopt significant rule proposals and the Commission cannot properly evaluate CBOT compliance with the core principles, unless CBOT's rulemaking procedures mandate prior consultation with members and affected market participants. While this may be good business practice, prior consultation with exchange members or industry participants is not required by the Commission. Moreover, in the case where a self-certified rule amendment is implemented immediately and without prior notification or consultation with CFTC staff, staff's due diligence review of the rule amendment's compliance with the Act, including applicable core principles, and Commission regulations, or the assessment of the rule's potential impact on the markets, necessarily takes place after-the-fact. In any case, as noted above, DMO staff is already well aware of the issues related to large open interest and the availability of the "cheapest to deliver" security that CBOT's rule is meant to address. Under these circumstances, an extensive discussion of that issue with market participants prior to the adoption of the rule amendments might have been unwise to the extent to which market participants would have been able to misuse that information in connection with trading in any contracts that were listed at the time of the CBOT's submission.

According to the FIA, while neither the CEA nor the Commission's regulations prescribe procedures that DCMs must follow in adopting rules, DCMs should follow the requirements found in § 40.5(a)(1)(iv) ("explain the operation, purpose and effect of the proposed rules…") and in § 40.6(a)(3)(iv) (explain "any substantive opposing views not incorporated into the rule").

The Division notes that DCMs are not required to comply with § 40.5(a)(1)(iv) with respect to self-certified submissions. That section applies exclusively to voluntary submission of rules for Commission review and approval. With respect to § 40.6(a)(3)(iv), which does apply to self-certification filings, the CBOT apparently took a limited view of the requirements of that provision and stated that, "there were no opposing views among the CBOT Board of Directors concerning these amendments." However, CBOT's comment letter, posted on the Commission's website, does include an extensive discussion of the opposing views expressed in the FIA letter.

2. The Aggregation Requirements Will Lead to Violations of the Limits

According to FIA, the CBOT Notice announcing the rule amendment provides that "all positions in accounts for which the person … controls trading shall be aggregated [and] a 10% or more financial ownership interest in an account constitutes control." It was alleged that this creates a problem because the bookkeeping systems used by clearing firms for purposes of large trader reports and position limits focus on control and cannot track positions based on ownership.

The Division notes that position limits are not useful without an aggregation requirement.[9] The aggregation standard applicable to the subject position limits, referred to by FIA, was not established by CBOT as part of the subject rule amendment; instead, the applicable standard is the CBOT's pre-existing aggregation standard that currently applies to all other CBOT contracts for purposes of complying with position limits and for large trader reporting. The Division further notes that the aggregation standard applicable today is the same aggregation standard that applied when, as noted above, the CBOT had more restrictive position limits on its Treasury futures contracts during the 1980s. To the Division's knowledge, there were no bookkeeping concerns with regards to tracking positions based on ownership at that time. Moreover, that same aggregation standard is found in Commission regulations (see Commission Rule 150.4 and Appendix B to Part 38, Core Principle 5, Section (b)(5)). In addition, the CBOT points out that, under this amendment, it "is not aggregating accounts any differently than it does in any other context," with the single "more liberal" exception that "independently controlled accounts owned by separate legal entities (irrespective of whether they share a parent) will be disaggregated." Therefore, if aggregation presents a bookkeeping problem with respect to compliance with the subject position limits, it is a problem that already exists, not one created by this rule amendment.[10] In view of the above, the Division does not believe that the CBOT's aggregation provisions violate the Act or Commission regulations.

FIA also points out in a footnote that Commission Regulation 150.3 and CBOT Rule 425.05 grant exemptions from position limit aggregation rules to the positions of "eligible

[9] Aggregation is the principle under which all futures positions owned or controlled by one trader (or group of traders acting in concert) are combined to determine reporting status and compliance with speculative position limits.

[10] In that regard, the implication of this argument is that if market participants cannot comply with the aggregation standard in the CBOT's U.S. Treasury futures markets, then market participants may not be complying with the identical aggregation standard in other CBOT contract markets. Separate from the matter involving the CBOT's Treasury futures contracts, Division staff will review market participant compliance with the aggregation standard in those other CBOT contract markets.

entities" (as defined in § 150.1(d)) if the positions are carried in separate accounts of an independent account controller. However, the exemption specifically does not apply to spot month limits such as those set out in the subject CBOT rule amendment (see § 150.3(a)(4)).

In addition, FIA notes that the problems posed by the aggregation requirement also apply to: (1) FIA member firms that are primary dealers in government securities and have multiple desks trading treasury futures and options for their own book; (2) FCMs whose broker-dealer and foreign affiliates operate on different platforms than the FCM; and (3) FCMs with an investment of more than 10% in a hedge fund. Given these problems, "it is almost inevitable that firms will go over the limits inadvertently."

As stated above, to the extent that there are any compliance concerns, such issues are pre-existing under the CBOT's and Commission's existing aggregation standards, and such concerns are not created by the subject amendment. Furthermore, the CBOT notes that these position limits have been implemented for the specific purposes outlined in its comment letter (*i.e.*, to prevent manipulation and price distortion) and "inadvertent breaches of the limits will be handled in that context, as with other products that have position limits."

3. Position Limits Could Affect the Pricing of the Treasury Contracts

According to FIA, the Treasury futures markets currently operate efficiently, with commodity pool operators, commodity trading advisors, and other speculators typically rolling their positions forward before the first notice day, while hedgers can carry positions into the delivery month. It is alleged that a position limit will have one of two effects, either: (1) hedgers and other large institutional users will scale down their positions to ensure they stay under the limits; or (2) there will be a second "roll" during every expiration. The second roll, by hedgers seeking to avoid the position limits, will force those hedgers to become price takers in a less liquid market, facing buyers who know there is going to be a forced liquidation. Thus, "a second roll is itself likely to **cause** an artificial price" (emphasis in original).

As noted above, the Act requires a DCM to list contracts that are not readily susceptible to manipulation and mandates the use of position limits when necessary and appropriate to reduce the potential threat of manipulation. The Act does not require a DCM to provide exemptions from its position limit rules. Division surveillance data show that positions in excess of the position limits during the last ten days of trading have been rare, and as noted above,

during the recent instances in which there have been such positions they have been a serious surveillance concern. Division staff further notes that hedgers may avoid the problem of the second roll by: (1) rolling their positions forward at the same time as speculators (not an optimal solution, but one that provides a more liquid market); or (2) opting to trade some of their positions on a competitor market, thus bringing greater liquidity and efficiency to that other market.

Moreover, the Division notes, as pointed out in the CBOT comment, that in view of the confidentiality requirements that apply to both Commission and Exchange position information, it is not clear how persons trading opposite hedgers in a second roll example would know there is a forced liquidation (see § 8). In other words, traders cannot be certain whether any other trader actually has a position over the limit that must be liquidated.

The Division further notes that because the position limits apply to both long and short position holders, in many instances there will be offsetting pressure to scale down positions from both sides of the trade. Moreover, many markets have position limits that require traders to reduce their positions as a contract draws closer to expiration without apparently causing the price distortion that the FIA suggests above. In addition, the Division's surveillance experience with markets in which predictable rolls do occur, for instance the rolling of long positions related to commodity index trading in physical commodity markets, such as the Goldman Sachs Commodity Index, has not caused the problems the FIA letter suggests.

Finally, the CBOT also points out that, "with respect to liquidity during the last 10 trading days of an expiring contract, there are few circumstances that compromise liquidity more than a dominant position holder, who by virtue of market congestion … may find itself able to exert market power." In other words, under current circumstances, market liquidity near contract expiration may be in even greater jeopardy without a provision limiting the size of positions that can cause pricing distortions.

4. Position Limits Will Drive Market Users from the Futures Markets

FIA argues that artificial limits on the size of positions will make the CBOT market less attractive to the largest users of futures and options markets. These large users have other alternatives – the cash, repo, OTC option and swap markets – and may withdraw from the futures market rather than assume the additional risk of, for example, a second roll. As the largest users

withdraw, other smaller users may become reluctant to use the market for fear they too may hit the limit, thus bringing even greater disruption to the market.

It is axiomatic that no entity has a greater stake in the commercial utility, viability and success of the CBOT Treasury contracts than the CBOT. Staff does not believe that the CBOT would take an action that might affect the viability of its contracts and possibly result in a reduction in trading activity, unless, in its business view, the alternative – failing to act – would have even worse consequences. In that regard, the observed price distortion which occurred during the last month of trading in the June 2005 10-Year U.S. Treasury Note futures contract was widely recognized by market participants, CBOT and Division surveillance staff. Staff notes that prior to the CBOT adopting position limits on its Treasury futures contracts, trade publications, such as the Morgan Stanley's *The Interest Rate Strategist* dated May 25, 2005, openly commented that the observed price distortion made the CBOT Treasury futures market less useful and recommended that clients shift trading to alternative markets, such as the cash and swap markets. The CBOT, recognizing that it needed to take action to protect its Treasury futures contract markets from price distortions, decided to adopt the subject position limits. Therefore, assuming the Act and Commission regulations are complied with, the Division does not believe a DCM should be prevented from taking actions to protect its own markets from disruption. In fact, § 5(d)(1) of the Act specifically provides that a DCM "shall have reasonable discretion in establishing the manner in which it will comply with core principles."

According to MP, the position limits rule discriminates against large commercial users of financial futures. Commission staff notes that the rule is intended to protect against price distortions caused by large positions held into the spot month, and that large commercial users are most likely to be the ones holding such positions. It is the Exchange's duty to protect the market against price distortions regardless of who the position holders are.

According to MP, the CBOT's current tools for addressing delivery problems are sufficient. It was noted that the contract is designed to handle multiple deliveries and the CBOT Market Surveillance Division and the Commission already have extraordinary latitude to work with large position holders to address delivery problems. As noted above, staff believes no one has a greater stake in the success of this contract than the CBOT. If the CBOT believed its existing tools were sufficient to handle delivery problems in this contract, it would not have

taken action to impose position limits. As long as the Act and regulations are not violated, the staff does not believe that it should substitute its business judgment for the CBOT's in this regard.

Finally, according to MP, position limits will affect the long term viability of the contract. A successful futures contract needs both "open-interest customers" (hedgers) and "trading or volume customers" (speculators). If the open interest customers move to interest rate swaps as a result of the limits, the sustainability of the financial futures complex could be at risk since trading customers cannot exist without their counterpart. Again, staff believes that no one has a greater stake in the long term viability of the contract than the CBOT. As noted, as long as the Act and regulations are not violated, the Division does not believe an Exchange should be second guessed about the actions it takes to protect the viability of its own contract.

5. Position Limits Are Not Necessary

FIA concedes that deliveries during some recent expirations have been larger than normal and that some of the shorts had to deliver securities in addition to the CTD securities. Nevertheless, FIA argues that this should not be a cause for concern, noting that the CBOT itself stated in its June 29 notice, "Market factors will thus dictate whether the futures contract prices a single-issue or a multi-issue delivery." FIA believes a concern that market participants with very large positions are in a position to dictate the value of the contract is ill-founded as long as the supply of securities actually available for delivery exceeds the open interest. It was noted that position limits serve one purpose – to reduce the possibility of a corner or squeeze – and there has been no indication that Treasury Bond or Note deliveries have either caused or exacerbated any market dislocations. Furthermore, according to MP, the CBOT's rush to act is ill-advised and short sighted. It does nothing to address the large speculators and arbitrage accounts who are the instigators of the current problem, nor does it address the underlying economics that created their opportunity to profit from current unusual market conditions.

The CBOT comment letter offers the following detailed rationale for its action. Large deliveries alone do not necessarily indicate a problem. The possibility of delivery is the link between the futures price and the price of the underlying. It is the convergence between these two prices that makes the contract relevant and useful for market participants. Recently, a confluence of factors across the cash market, the repo market and the futures market for Treasury

securities furnished the context for the Exchange's decision to impose position limits. These factors included: (1) the recent and present combination of low yields and a flat yield curve strongly favors delivery of Treasury issues with relatively short durations and short times to maturity; (2) the issue sizes of Treasury securities that are now available for delivery happen to be unusually small; (3) open interest in Treasury futures has grown rapidly and dramatically relative to the underlying cash market; and (4) "the increased incidence of fail epidemics since 9/11 in the cash Treasury market, and especially in the Treasury repo market, has eroded certainty in the cash Treasury market in ways that impair the ability of market participants to perform cash-futures arbitrage." With regard to the last point, CBOT noted that the loss of price convergence in the futures market adversely affected trading in the cash market. The Exchange concludes that:

> Against this backdrop, and in consideration of the Exchange's assessment of past and upcoming contract expirations, the CBOT's decision to implement position limits was a prudent and proactive initiative intended to preserve the integrity of price convergence between cash and futures, to insulate Treasury futures from potential manipulative conduct and the perception of "squeeze" conditions, and more generally, to make fair valuation of these contracts less susceptible to distortion arising from an increasing lack of discipline and trade certainty in the Treasury financing market.

The CBOT further notes that the position limit rule does not preclude multi-asset deliveries, nor was that the CBOT's intent. Rather, it was intended to ensure that a single participant (or multiple participants acting pursuant to a common plan) "cannot establish and hold a dominant and potentially destabilizing position into the last ten trading days of an expiring contract."

The Division concurs with the CBOT's observations. Moreover, as noted above, the Division's surveillance staff has experienced several problem liquidations in recent months. The CBOT's action appears reasonable in light of those experiences and appears consistent with the Exchange's self regulatory responsibilities, as discussed below.

According to MP, temporary rules are damaging. New rules frequently have unintended consequences and even "temporary rules" will affect market participant behavior and contract valuations on an ongoing basis. Once the CBOT implements this rule, they will be under pressure to use it whenever the repo markets imply a shortage in the CTD and participants will take this into account when they decide to take positions in futures relative to other asset classes.

While the CBOT comment letter refers to position limits as "an effective short-term alternative," the Exchange rule submission itself does not characterize this as a "temporary rule." Thus, the Commission is appropriately treating this as a rule that is intended to remain in effect to address an ongoing concern. Now that the rule is in effect, market participants can be expected to adjust their behavior accordingly in future liquidations. The CBOT has noted that it will review the position limit rules over time and monitor the market conditions that caused the Exchange to decide to establish position limits. Any future amendments to the rules can be expected to have the same purposes (protection against manipulation or price distortion) and will be subject to the same standards of Commission review as this submission.

6. Position Limits Should Not Be Applied to Contracts with Open Interest.

FIA argues that the CBOT's action fails both tests of former Commission Rule 5.3; *i.e.*, that changes in contract months with open interest may only be implemented where the rule change would not affect the value of existing positions or where traders had notice of the impending change prior to opening their positions.[11] It was noted that, in fact, traders did not have notice of this change prior to opening their positions and the position limits announcement did affect existing positions. Specifically, according to FIA and EMF, the rule amendment resulted in an immediate 25 basis point decline in the repo rate for the December 10-Year contract's CTD. EMF further states it believes the amendment should be deferred to the March '06 contract. FIA concedes that Commission Rule 5.3 was removed following adoption of the CFMA, but argues that "the policy … is still sound." In addition, EMF argues that position limits in a futures contract affects open interest, which, in turn, affects the value of the securities most likely to be delivered, thus damaging futures traders with open positions in the contract.

Ultimately, the Commission is bound by the CEA. Rule 5.3 was withdrawn because it was directly contrary to the CEA, as amended by the CFMA, which provides that a DCM can implement a rule change (in a non-agricultural contract) by certification, regardless of whether there is open interest in the affected contract or whether traders had notice of the impending change. Also, staff notes that Congress was aware of this issue related to implementing rule changes for application to existing contracts when it established the self-certification provisions.

[11] The Commission adopted Regulation 5.3, effective January 25, 2000, to allow exchanges to list new contracts under self-certification. Part 5, including Regulation 5.3, was deleted following the enactment of the Commodity Futures Modernization Act of 2000.

In that regard, Congress specifically carved out (in § 5c(c)(2)(B) of the Act) an exception to the self certification provisions whereby material rule changes that apply to months with open interest in contracts for an agricultural commodity enumerated in § 1a(4) of the Act are subject to Commission prior approval. If Congress intended to apply the same exception to non-agricultural products, it had the opportunity to do so and chose not to include other products such as Treasury securities within this provision.

Furthermore, the Division has long held that position limits generally are price neutral. This is because position limits should not have a positive or negative pricing bias as they apply equally to both long and short traders and, more importantly, position limits do not affect the economic characteristics of the commodity underlying the futures contract – *i.e.*, the terms and conditions that define the quality and quantity standards, the delivery standards and procedures, *etc*. Thus, in normal situations the imposition of a position limit should not affect the value of a trader's existing position. However, it is possible that the adoption of a position limit may affect the pricing basis of a contract if the effect of the limit is to diminish the likelihood of congestion at contract expiration and thereby remove or diminish an existing pricing anomaly. In this regard, it appears that the subject position limits could have affected the value of existing positions or the value of cash Treasury securities such as the CTD security if traders were already anticipating tightness in the availability of the CTD at contract expiration, due possibly to the expected actions of a dominant trader with market power. For example, if the alleged price decline in the CTD security was shown to be the result of the CBOT's rule amendment, it would appear that the futures market had been overpricing the CTD security because of the market's belief that the CTD security would be in scarce supply and that it would be difficult for shorts to obtain it prior to and during the delivery month. That is, the market likely was pricing a "congestion premium," which may be viewed as a pricing distortion. The cited decline in the repo rate may be evidence that the CBOT's action had the intended effect of removing the pricing anomaly.

Staff believes that the possibility that the CBOT's action had a price effect does not demonstrate that the rule changes violated the Act. As noted, any such price impact may have been ameliorative, by removing an existing distortion. Moreover, staff notes that in carrying out its self-regulatory responsibilities, a DCM must balance the potential effect of its actions on persons with open positions against the harm to other market participants that may follow from

failing to act and allowing a price distortion to occur or persist. By imposing position limits for the December and later contract months in June, the CBOT may have affected the value of some open positions. However, open interest in those contract months was relatively low, as noted above. Moreover, failing to act and allowing a price distortion to occur in the December future could have caused harm to even more market participants.

Staff further notes that other exchanges have adopted, or reduced existing, position limits and applied them to existing positions. For example, the COMEX Division of the New York Mercantile Exchange periodically reduces the limit for its copper contract based on stocks in approved warehouses. Such actions apparently have not impacted trading in the copper cash and futures markets.

With respect to EMF's suggestion that the position limit rule amendments be deferred to March 2006, it should be noted that the futures market has already adjusted to the CBOT position limit rules. Restoring the prior rule just for the December liquidation could cause market dislocations and price distortions with respect to positions already taken in response to the existing position limits amendment.

7. Any Position Limits Should Provide a Risk Management Exemption

FIA suggests that, if the CBOT will not repeal the position limits rule, it should be revised to include a risk management exemption. FIA notes that Congress has prohibited the Commission from limiting hedge exemptions in the context of Commission-imposed speculative position limits (for certain agricultural commodities). Imposing position limits without hedge exemptions forecloses market participants with hedging needs from using the CBOT Treasury contracts during the last ten trading days of the contract. FIA argues there is no risk of a shortage of deliverable securities and no reason to deny hedgers an exemption from any position limits the Exchange may adopt.

Commission staff agrees that § 4a(c) of the Act does state that the Commission must provide bona fide hedge exemptions to its speculative position limits for enumerated agricultural commodities. However, that provision does not apply to either non-agricultural products or DCM position limit regimes. In fact, the Commission's regulatory provisions very pointedly give DCMs the discretion whether to grant hedge exemptions from exchange-set position limits. In fact, in granting exemptions, exchanges are obligated to take into account whether granting an

exemption would be "in accord with sound commercial practices or exceed an amount which may be established and liquidated in an orderly fashion."

DMO understands that one factor contributing to the CBOT decision not to establish hedge exemptions from the Treasury securities position limits was that, given the widespread impact of interest rate risk, it would be difficult to establish a useable "hedging" standard in the context of Treasury products. Furthermore, the CBOT comment letter notes that,

> Given the stated objectives of the position limits – [preserving the integrity of price convergence between cash and futures, insulating Treasury futures from manipulative conduct and the perception of "squeeze" conditions and making fair valuation of the contracts less susceptible to distortion] – hedge exemptions would render the limits meaningless as very few large-scale positions in these contracts would fail to qualify for such an exemption.

The CBOT also points out that the position limits do not preclude a participant's ability to hedge interest rate exposure with Treasury futures contracts. They merely limit the extent to which such exposure can be hedged in the expiring contract during that contract's last ten trading days. Furthermore, as noted above, most hedgers have rolled their positions over to the next contract month before the last ten trading days of the expiring contract month. Therefore, hedgers should be able to utilize the CBOT's futures contracts to meet their hedging needs up to, but not including the last 10 trading days of the expiring contract month.

8. Position Accountability is Superior to Position Limits

FIA notes that the CBOT's already existing position accountability thresholds are lower than the new position limits. While these standards would not stop a trader from accumulating a large position in the first place, the CBOT does have the authority to require market users to supply information regarding the nature of their positions, their trading strategy and, if applicable, their use of the contract to hedge cash and repo exposures. The Business Conduct Committee (BCC) may suggest – and if need be order – a firm with a large position to reduce its position to a level, and within a timeframe, specified by the committee.

The CBOT points out that, if it believed position accountability standards would fulfill its self-regulatory responsibilities, it would not have imposed position limits. It notes that it is not uncommon for large market participants to establish positions many times the new limits prior to liquidating or rolling these positions. The CBOT argues that, "it would be unacceptably

disruptive if the Exchange, under the banner of enforcement of position accountability, were to prevent the establishment of positions that in nearly all cases are rolled or liquidated prior to the contracts' last ten trading days."

The CBOT further notes that, contrary to FIA's contention, the BCC does not have the authority to order a position reduction. That power is reserved to the Board of Directors and requires emergency action, "the most disruptive action an Exchange or the Commission can take." Thus, the CBOT argues that imposing position limits is "the most effective short-term alternative for simultaneously fulfilling the Exchange's self-regulatory mandate, minimizing the impact on the risk management options of our customers, and reducing the likelihood of regulatory interference in the price discovery process."

ATTACHMENTS:

- CBOT rule amendment certification letter dated June 28, 2005.
- Draft position limits approval letter.
- Comment letters.:
  1) EMF Financial Products, LLC. letter dated June 30, 2005.
  2) Futures Industry Association letter dated August 1, 2005.
  3) Chicago Board of Trade letter dated August 10, 2005.

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