

CHICAGO BOARD BROKERAGE, L.L.C.

141 W. JACKSON BLVD.  
SUITE 3010  
CHICAGO, IL 60604-2994  
TELEPHONE 312-341-7796  
888-835-8200  
FACSIMILE 312-341-3269

101 HUDSON STREET  
JERSEY CITY, NJ 07302-3908  
TELEPHONE 201-557-5042  
FACSIMILE 201-557-5971

COMMODITY  
TRADING COM  
MISSION  
OFFICE OF  
STAFF



APR 27 6 07 PM '98  
Chicago Board Brokerage

98-6  
52

April 27, 1998

## COMMENT

Jean A. Webb  
Secretary of the Commission  
U.S. Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, N.W.  
Washington, D.C. 20581

APR 28 10 24 AM '98  
COMMODITY FUTURES  
TRADING COMMISSION  
RECEIVED FOR  
PUBLIC RECORD

Re: Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market

Dear Ms. Webb:

Chicago Board Brokerage, L.L.C. ("CBB") welcomes the opportunity to comment on the Commodity Futures Trading Commission's ("Commission's") concept release ("Concept Release") concerning the regulation of exchanges of futures for physicals transactions ("EFPs").<sup>1</sup> CBB is a newly established government securities broker that will provide screen-based brokerage services in the U.S. Treasury securities market.

### I. CBB and Its Brokerage Services

The description of CBB and its proposed brokerage services in the Concept Release is both incomplete and inaccurate. First, no direct corporate subsidiary relationship currently exists between the Chicago Board of Trade ("CBOT") and CBB. On September 19, 1997, the CBOT completed the transfer of its ownership interest in CBB to Ceres Trading Limited Partnership ("Ceres") (60%) and Prebon Alliance (40%). Ceres is a limited partnership owned by the members of the CBOT; the CBOT serves as Ceres' general partner. Prebon Alliance is a wholly-owned subsidiary of Prebon Yamane (USA) Inc., a global institutional broker. Prebon and Ceres are both actively involved in the development of CBB's electronic brokerage services, and each has equal representation on the CBB Board of Directors. CBB, now in the process of enlisting customers and constructing its telecommunications network, plans to commence operations in July 1998. Contrary to the indications contained in the Concept Release, CBB cannot be characterized simply as a "proposal" of the CBOT.

Second, as a government securities broker registered with the U.S. Securities and Exchange Commission ("SEC") under Section 15C of the Securities Exchange Act of 1934, CBB does not serve as a forum for the discovery of futures prices. In calculating prices for basis trades, CBB

<sup>1</sup> See 63 Fed. Reg. 3708 (Jan. 26, 1998).

utilizes a futures price and a futures conversion factor disseminated by the CBOT. Using the electronic facilities provided by CBB, CBB's customers may bid and offer to exchange futures contracts for Treasury securities at a spread. This process, however, in no way affects the price of any futures contract, which is fixed on the trading floor of the CBOT, a designated contract market. As with any EFP arranged through more traditional brokerage activities, the futures contract component of the CBB basis trade will not exist, until and unless it is acknowledged and accepted by the host contract market (*i.e.*, the CBOT) and its clearinghouse, the Board of Trading Clearing Corporation ("BOTCC"). The CBB System simply serves as one additional means for the parties to assemble a proposed EFP.

Clearance and settlement of the cash legs of CBB basis trades are also substantially similar to clearance and settlement of basis trades arranged through the traditional brokers. The clearance and settlement functions for securities transactions executed through the CBB system will be performed by the Clearing Corporation for Options and Securities ("CCOS"), a wholly-owned subsidiary of BOTCC.<sup>2</sup> Thus, CBB will not act as an intermediary in any aspect of the clearance or settlement of basis trades executed on the CBB System.

In sum, CBB is designed to serve as the electronic equivalent of the traditional brokers identified in the Concept Release. CBB should not be singled out as the type of execution facility that the Concept Release characterizes as "functionally the equivalent of designated contract markets."<sup>3</sup> CBB will neither execute any futures transaction nor clear the futures leg of any basis trade. It will merely facilitate the electronic negotiation of a limited set of transactions exempt from the Commission's purview by statute, utilizing prices set on a designated contract market.<sup>4</sup>

## II. Electronic Basis Trading Facilities in General

In addition to the particular concerns relating to CBB, we are also troubled by the disparate treatment of the operators of electronic basis trading facilities as a group in the Concept Release. Electronic basis trading appears to be chosen for heightened regulatory scrutiny by the Commission for no reason other than the perceived "structural differences" between these facilities and traditional methods for the execution of EFPs.<sup>5</sup> The former is mistakenly described as providing a "formal market environment," while the latter is noted to take a "bilateral, over-the-counter approach to the

---

<sup>2</sup> The Concept Release mistakenly identifies CCOS as a "registered as a clearing agency with the SEC." Although CCOS will perform functions that are substantially identical to a registered clearing agency, CCOS will operate pursuant to the terms and conditions of a temporary exemption from registration as a clearing agency under Section 17A of the Exchange Act. See Exchange Act Rel. No. 36573 (Dec. 12, 1995), 60 Fed. Reg. 65076 (1995).

<sup>3</sup> Concept Release at 3720.

<sup>4</sup> In any event, we certainly hope that the Commission will not take any regulatory action in connection with this Concept Release (including any characterization of CBB), which could affect CBB as an entity, without first affording a meaningful opportunity for CBB to present its views, consistent with traditional notions of fair notice and due process.

<sup>5</sup> Concept Release at 3719.

negotiation of trades.”<sup>6</sup> For the reasons stated below, CBB believes that such artificial distinctions between electronic and traditional brokerage activities are simply unwarranted.<sup>7</sup>

First, an electronic trading system for basis trades simply facilitates (but does not replace) the “bilateral” negotiation between the parties to an EFP. CBB and inter-dealer brokers simply enable the parties to communicate electronically, rather than telephonically (or face-to-face); this is a change only in form, not in substance. Increasingly, market participants prefer electronic communication to telephonic conversation because the former reduces the incidents of error and potential “out trades.” It also simplifies post-trade processing. Faster and more reliable means of communication should require less, not more, regulation by the Commission.

Second, just as with any EFP arranged by “traditional” means, a legally binding futures contract for an EFP assembled through an electronic system may not come into existence unless and until it complies with all of the following requirements:

- The transaction is consistent with the EFP rules of a designated contract market, which have been reviewed and approved by the Commission;
- The EFP meets the applicable reporting and recordkeeping requirements imposed by a designated contract market; and
- The contract market causes its clearinghouse to accept, recognize and record the futures side of the tendered EFP.

Third, the operator of an electronic basis trading facility has no authority to permit any particular type of EFP that is inconsistent with the regulatory oversight of the host contract market. Like any broker operating in the Treasury securities market, the facility operator assists the parties in identifying a particular cash transaction to be paired with a futures contract. Such facilitation efforts, however, are subject to the ultimate power of the Commission-regulated contract market to accept or reject the futures contract.

CBB believes that no meaningful “structural differences” exist between electronic and traditional brokerage activities in view of various safeguards that currently apply to both. The Concept Release fails to cite any adverse market developments associated with the operation of electronic basis trading facilities, and we are not aware of any compelling reason for regulating them differently. Indeed, the smooth and efficient operation of the Treasury securities market itself

---

<sup>6</sup> *Id.*

<sup>7</sup> In this regard, CBB generally agrees with, and supports, the views set forth in The Bond Market Association's (“BMA”) comment letter to the Commission with respect to the status of electronic basis trading. See Letter from Paul Saltzman, Esq., Senior Vice President and General Counsel, BMA, to Jean A. Webb, Secretary of the Commission (Apr. 1, 1998).

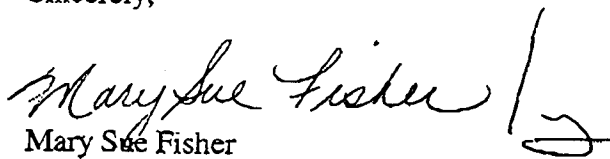
confirms that the existing regulatory structure is adequate as currently structured. Accordingly, CBB submits that no additional oversight by the Commission is needed.<sup>8</sup>

To the extent that minor differences exist between electronic and traditional brokerage activities, these differences actually help to mitigate many of the concerns with EFP transactions that the Commission highlights in its Concept Release. The Commission raised concerns, for example, that the statutory exception for EFP transactions might be used as a ruse to effect futures transactions (without a corresponding transfer of a cash commodity) outside of a regulated contract market, possibly at non-competitive prices.<sup>9</sup> Brokerage services, such as those provided by CBB, cannot be used effectively to abuse the statutory exception for EFP transactions. First, as the Commission recognizes, transactions arranged by CBB and similarly-situated brokers are done at competitive prices. Second, based upon CBB's arrangements with CCOS and BOTCC, and their procedures for netting the delivery obligations for securities, there is no effective way for parties to avoid the delivery of the cash commodities associated with a basis trade. The Commission should not take any action that would discourage CBB and others from development of order execution techniques that help achieve the Commission's objectives without the cost of additional regulation.

\*\*\*\*\*

We hope that our comment will prove useful to the Commission and its staff in their ongoing assessment and review of EFP regulation. If the staff has any questions, please do not hesitate to contact me.

Sincerely,



Mary Sue Fisher  
Managing Director  
Legal and Compliance

---

<sup>8</sup> CBB also urges the Commission to recognize the role that electronic trading is assuming in the international financial markets. The regulatory environment in other countries has allowed foreign competitors to bring their products to market quickly. Time to market is an essential factor in competing for market share with electronic trading systems. The recent experience in the European futures market underscores how quickly electronic systems can change the competitive balance. Trading desks are already crowded with electronic offerings; they will not accommodate latecomers. To compete, electronic systems must be able to respond quickly to market and technological change. Adding additional layers of regulation to these systems will further undermine the ability of US firms to compete effectively.

<sup>9</sup> Concept Release at 3713