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COMMODITY FUTURES TRADING COMMISSION RECEIVED

Chicago Board of Trade

(55)

April 27, 1998

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COMMENT

Ms. 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

COMMODITY FUTURES TRADING COMMISSION RECEIVED FOR PUBLIC RECORD APR 30 10 28 AM '98

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

Dear Ms. Webb:

The Chicago Board of Trade ("CBOT®" or "Exchange") and the Board of Trade Clearing Corporation (the "Clearing Corporation") respectfully submit this letter in response to the Commodity Futures Trading Commission's ("Commission") January 26, 1998 Federal Register Concept Release that requests comment on whether the Commission should re-evaluate its approach to the regulation of noncompetitive transactions executed on or subject to the rules of a contract market ("Concept Release")[1]. The Exchange understands that, with respect to that the portion of the Concept Release that relates to "block trading," the Commission has extended the comment period to September 1, 1998.

I. Introduction

The CBOT is the world's oldest and largest futures exchange. In 1997, more than 242 million contracts, covering a broad spectrum of commodities and financial instruments, were executed on the floor of the Exchange. Over the past 150 years, market users throughout the world have relied on the Exchange's open and competitive markets to discover prices and to manage the risk associated with their exposure to the fluctuations of commodity prices and interest rates.

The Clearing Corporation performs clearing and settlement functions for approximately 120 members for futures and options trades executed on or through the facilities of the CBOT and affiliated exchanges. The Clearing Corporation's primary responsibility is to ensure the financial integrity of all futures and options contracts traded on the CBOT. Such trades represent approximately one-half of all futures and options contracts executed on the markets located in the United States.

The Clearing Corporation has been guaranteeing the financial integrity of these futures markets for over 70 years. It is the only clearinghouse in the world with both an "AAA" rating from Standard & Poors Corporation and $100 million in default insurance. The

[1] 63 Fed. Reg. 3708 (January 25, 1998).

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Clearing Corporation has well-developed financial safeguards and operational and risk procedures in place to protect markets from possible member defaults.

As a general matter, the Exchange believes that any proposal that reduces liquidity in its markets would substantially raise costs for market users and impair the performance of cash markets that rely on our liquid futures markets both for hedging and price discovery.

Accordingly, the CBOT urges that the Commission refrain from any action that would jeopardize the liquidity and transparency of the CBOT's futures markets and, consequently, their price discovery and risk management functions. The CBOT respectfully reminds the Commission that the general precept stated above is derived from sound and long-standing policies that recognize the national interest in open and competitive futures markets. The history and legal structure of the Commodity Exchange Act ("CEA") reflects a clear congressional intent that, in order to protect the public, all futures trading is to be conducted openly and competitively through and on the facilities of approved contract markets, except in extremely limited and expressly defined circumstances, i.e., exchanges of physicals for cash, office trades and transfer trades.

Therefore, the Exchange urges the Commission to continue to fulfill its statutory mandate to ensure open and competitive futures markets — markets that foster liquidity and enable reliable price discovery and effective risk management. In short, the existence of truly open and competitive markets is absolutely critical to the maintenance and preservation of the liquidity of futures markets.

In light of the unquestionable importance of liquidity to the futures markets, the test for determining if a noncompetitive transaction should be exempted from the statutory open and competitive trading requirement must necessarily be whether the proposed transaction has the potential to adversely impact the liquidity of the related futures market. Therefore, the CBOT submits that any Commission determination that a noncompetitive transaction should be exempted should be strictly supported by significant and substantial economic evidence establishing that the type of transaction will not damage the liquidity and efficiency of the related futures market.

II. Background

A. "Noncompetitive" Transaction Defined

At the outset, it is worth noting that the Commission's use of the term "noncompetitive transaction" has caused some confusion within the industry.[2] Nevertheless,

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[2] Based on feedback we have received from industry participants, a number of participants are offended by what they believe to be the misuse of the term "noncompetitive transactions." In particular, these participants reason that the use of the adjective noncompetitive has been misapplied to such transactions as EFPs

the Exchange understands the term "noncompetitive transactions" to mean futures contracts that are negotiated or executed outside of a Commission-approved, exchange-traded, open and competitive, centralized market.

For example, EFPs are noncompetitive transactions because the futures leg of the EFP is negotiated and executed outside of an open and competitive, centralized futures market. Of course, as discussed in Section III of the Exchange's comment letter, EFPs represent an appropriate exemption from the open and competitive execution requirement for futures transactions.

B. The Vast and Active Cash Market That Underlies The Futures Market Is Critically Dependent Upon The Price Discovery and Risk Management That Results From Liquid and Transparent Futures Markets

Liquid futures markets provide a low-cost, effective method for market participants to hedge and manage their exposures to interest rates, commodity prices, stock prices, and exchange rates.

Treasury futures, for example, play an enormous role in the huge Treasury securities market by allowing primary dealers to hedge their exposure to interest rates at auction and allowing them to bid more aggressively for Treasury debt. A liquid Treasury futures market allows the government to fund its operations at a lower cost, saving American taxpayers millions of dollars in interest expense on the public debt. In addition, Treasury futures have caused the cash market to become more competitive by reducing bid-ask spreads in the cash market, saving the economy billions of dollars in efficiency costs. Notably, when Treasury futures cease to trade, Treasury cash market activity slows and bid-ask spreads widen.

A liquid Treasury futures market also helps banks manage the repricing mismatches that result in funding long-term assets such as mortgages with short-term deposits, effectively allowing banks to provide more home mortgages. Corporations benefit from liquid Treasury futures through obtaining better and more certain funding costs, which improves their performance in an increasingly more competitive global environment.

In the same vein, a liquid agricultural futures market helps farmers and processors hedge against commodity price risk and permits farmers to receive better prices for their production. The price discovery role of liquid agricultural futures is particularly important; it allows farmers and others in the agricultural markets to better plan production and consumption, making that sector more productive and competitive worldwide.

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because they believe that such transactions are negotiated and executed at "competitive" (over-the-counter) prices. In other words, industry participants are concerned that the perception will be that they or their customers have purchased or sold EFPs for an amount other than a duly negotiated "fair value;" when in fact, EFPs are negotiated and executed (over-the-counter) at competitive prices.

Liquid stock index futures and interest rate futures markets allow pension funds and mutual funds to change exposure to the stock and bonds markets quickly and at lower cost, providing cost savings and enhanced yield for the many millions of participants in those funds.

C. The CEA and Commission Regulations Mandate the Open and Competitive Execution of Futures Transactions on Federally Designated Contract Markets

The Concept Release carefully outlines the statutory and regulatory provisions of the Commodity Exchange Act and CFTC Regulation 1.38, which expressly require that futures transactions be executed openly and competitively by open outcry or the posting of bids and offers or by other equally open and competitive methods, in the trading pit or ring or similar place provided by a designated contract market.[3] Moreover, the Commission quotes the legislative intent that futures transactions be executed openly and competitively:

> the purpose of this requirement is to ensure that all trades are executed at competitive prices and that all trades are focused into the centralized marketplace to participate in the competitive determination of the price of futures contracts. This system also provides ready access to the market for all orders and results in a continuous flow of price information.[4]

In the past, the Commission has vigorously defended the open and competitive futures trading requirement. For example, the Commission denied a request of the Commodity Exchange, Inc. ("Comex") to permit certain noncompetitive gold and silver straddles to trade in an after-hours session because it believed that the session would not allow for a fully competitive determination of price and would interfere with Comex's ability to function as a centralized market. The CFTC stated that Section 4b of the Act "reflects Congress' belief that the public interest in the integrity of the markets would be protected by the execution of orders for futures trades by public outcry."[5] The Commission echoed the same belief when it referred to the economic justification for open and competitive futures trading as follows:

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3 Commission Regulation 1.38(a), reads, in relevant part, as follows:

> All purchases and sales of any commodity for future delivery, and of any commodity option, on or subject to the rules of a contract market shall be executed openly and competitively by open outcry or the posting of bids and offers or by other equally competitive methods, in the trading pit or ring or similar place provided by the contract market during the regular hours prescribed by the market for trading in such commodity or commodity option. . . . 17 C.F.R. §1.38.

4 Report of the Senate Committee on Agriculture and Forestry, S. Rep. No. 1131, 93rd Cong., 2d Sess. 16 (1974).

5 46 Fed. Reg. 32516 at 26518 (April 27, 1981) (disapproving Comex straddle session).

> It is generaly [sic] conceded that one of the primary purposes of the futures market and one of the chief justifications for it is to provide a common meeting ground for all orders to buy or sell in that market at any given time. That being so, if any of those orders are diverted from the common meeting ground and withheld from truly competitive bidding and offering, so that everyone interested may not have equal opportunity to buy or sell, the market falls short of that purpose and justification.[6]

More recently, the Commission declared in a November 6, 1997 Opinion and Order relating to the actions of several floor traders who were involved in the expiration of the Exchange's March 1996 Wheat contract,[7] that:

> the absence of 'true competition' calls into question the price discovery role of the exchange and could result in the loss of confidence in CBOT prices. As we recently stated, open and competitive execution is the <u>bedrock underlying public confidence</u> in the objectivity and fairness of futures trading.[8]

In summary, as Ralph S. Janvey cogently argued in his treatise, <u>Regulation of the Securities and Commodities Markets</u>:

> A central feature of the operation of contract markets and an integral part of their regulation under the CEA is the competitive execution of futures transactions. While limited exceptions are recognized by the exchanges and the Commission, the competitive execution is vigorously protected by Sections 4b and 4c, which prohibit noncompetitive trading except under the most stringent limitations.[9]

D. If The Commission Fails to Vigorously Defend and Uphold the Statutory Open and Competitive Futures Trading Requirement, the Commission Will Jeopardize the Critical Role Played By the U.S. Futures Markets In the National and World Economies

As a general matter, a primary function of futures exchanges is to funnel all potential

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6 56 Fed. Reg. 23516 at 23518 (April 27, 1981) (quoting from CEA Administrative Determination No. 123 (June 15, 1984)).

7 <u>In the Matter of CBOT's Settlement of Disciplinary Charges Against Scheck, Schaer, Bedore, Frey, Ieronimo, and Produce Grain, Inc., Related to the March Wheat Expiration on March 20, 1996</u>, 2 Comm. Fut. L. Rep. (CCH) ¶27,184 (Nov. 6, 1997).

8 <u>Id.</u> (Emphasis added.)

9 Ralph S. Janvey, Regulation of the Securities and Commodities Markets, 12.04 at 12-6 (1992).

trading interest into one location, thereby maximizing liquidity for all. By maximizing liquidity, futures exchanges best serve the public interest in effective price discovery and efficient risk hedging.

In evaluating the relative merits of consolidated markets and fragmented markets, the CFTC should bear in mind the market features that contribute to reliable price discovery and efficient risk hedging. It has been documented, for example, that markets are more efficient and liquidity is enhanced by: (a) the greater number of market makers; (b) the greater the number of market participants; © the more total volume flowing through the market; (d) the shorter the frequency of order arrival; and (e) the more equal information flow to market participants.[10] These factors are more likely to be found in centralized, consolidated markets than in fragmented markets.

Alternative mechanisms for trading the same contracts generally would not be able to serve the public interest in price discovery and risk management. This is because order flow and information flow would be split between at least two systems. Participants in one system would possess different information from participants in the other system, because, by definition, trading in the upstairs noncompetitive market would not be transparent to all market participants. By establishing an upstairs noncompetitive trading mechanism, volume and information flow would be diverted from the open outcry market. Ultimately, liquidity in the floor-based system would diminish. This, of course, would harm two vital functions of the futures markets: price discovery and risk hedging.

1. **Price Discovery**

Market structure affects the production of reliably informative prices. Traders, and others not directly connected to the markets, base their economic decisions on these prices. The best market structure, from a reliability standpoint, is one in which prices can always be found. This argues in favor of centralized markets and against fragmented markets. Organized, centralized futures markets, as currently structured, closely approximate a perfectly competitive market. Prices produced in competitive markets provide useful

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[10] Marco Pagano and Ailsea Roell, Transparency and Liquidity: A Comparison of Auction and Dealer Markets with Informed Trading, Journal of Finance, June 1996, at 579-611; Haim Mendelson, Consolidation, Fragmentation, and Market Performance, Journal of Financial and Quantitative Analysis, June 1987, at 189-207; Marco Pagano, Trading Volume and Asset Liquidity, Quarterly Journal of Economics, May 1989, at 2550274; Lester G. Telser, Organized Futures markets; Costs and Benefits, Journal of Political Economy, October 1977 at 977, at 969-1000; Kalman J. Cohen, Steven F. Maier, Robert A. Schwartz and David K. Whitcomb, An Analysis of the Economic Justification for Consolidation in a Secondary Security Market, Journal of Banking and Finance, 1982, at 117-136; J. Harold Mulherin, Jeffry M. Netter and James A. Overdahl, Prices Are Property: The Organization of Financial Exchanges from a Transaction Cost Perspective, Journal of Law and Economics, October 1991, at 591-644; Kalman J. Cohen and Robert M. Conroy, An Empirical Study of the Effect of Rule 19c-3, Journal of Law and Economics, April 1990, at 277-305; Sanford J. Grossman and Merton H. Miller, Liquidity and Market Structure, Journal of Finance, July 1986, at 617-637; and Lester G. Telser, Why Are There Organized Futures Markets, Journal of Law and Economics, April 1981, at 1-22.

information for making a variety of economic decisions. An organized, centralized, and active futures market brings to bear on futures prices the pooled knowledge of all participants in the market. These superior price predictions are made generally available by exchanges through wide dissemination of futures prices, thus enhancing transparency.

It is cheaper and more efficient to identify potential traders, search for the best bid or offer, and negotiate a transaction in an organized, centralized futures market. Information on supply and demand is concentrated in that market in a single futures price. All traders are able to acquire this information and the information (implicit in futures prices) is cheaply acquired by others who do not trade on the centralized market.

Fragmented futures markets offend this model from a price discovery standpoint. As trades move off the centralized exchange, the information content of those trades becomes unavailable to the floor population and to the locals who are critical to liquidity supply. This diversion of order flow and information flow increases the risks faced by locals, who have two ways of responding: withdraw from the market or widen bid-ask spreads. Either way, the centralized market becomes more expensive and less efficient for small and medium sized traders who cannot participate in the upstairs market, and who, as a consequence of this increased cost, will trade less frequently.

The ultimate consequence of noncompetitive transactions is that futures prices in the centralized, public market become less reliable and less informative. Fragmented markets increase price uncertainty, because the same contract could trade simultaneously at different prices. Price information and order flow information would not be universally available. Encouraging trading in noncompetitive, fragmented markets would defeat the public interest in reliable price discovery, the very objective that the CFTC is required by law to protect and preserve.

2. Efficient Risk Hedging

Encouraging noncompetitive and nontransparent trading alternatives would also degrade the efficient hedging function of centralized trading of futures. The reason is the same: fragmented markets reduce order flow and information flow to the centralized market, causing liquidity to be drained from the centralized market. The ability to immediately enter into transactions at reasonable costs in order to efficiently manage price risk would be diminished in a fragmented futures market. It has been shown that there is a more urgent demand for immediacy in futures markets than in stock markets.[11] Immediate order execution demands liquidity which is supplied by locals in the futures pits. These locals stand ready to

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[11] Sanford J. Grossman and Merton H. Miller, Economic Costs and Benefits of the Proposed One-Minute Time Bracketing Regulation, Journal of Futures Markets, Spring 1986, at 141-166; and Puneet Handa and Robert A. Schwartz, How Best to Supply Liquidity to a Securities Market, Journal of Portfolio Management, Winter 1996, at 44-51.

balance asynchronous order flow for a price, which is reflected in the bid-ask spread.

A centralized futures market consolidates order flow. The benefit of pooling order flow is striking: traders can find the best terms for their trades by reference to one trading venue, the floor of the futures exchange. In a market where traders can obtain the quotations of many competing market makers instantly and cheaply, there is only one effective bid and one effective offer at any moment in time. Therefore, consolidation of trading means trading at the best prices. In serving immediacy demands which are so crucial to futures customers, no other market structure can compare to the simultaneous, active bidding by hundreds of competing floor traders.

None of this would be true, of course, if futures markets fragmented. Traders and customers could never be certain they are obtaining the best prices for their transactions.

The adage, "liquidity attracts liquidity," is exemplified in the futures markets. Once potential buyers and sellers come to believe that a market is liquid, they direct more of their orders to it, setting a cycle in motion. The expanded order flow increases the frequency of buy and sell orders, thus reducing locals' inventory risk and permitting them to trade with lower bid-ask spreads. The lower spreads, in turn, attract more market participants, which lead to further reductions in spreads.

Larger order flow implies narrower bid-ask spreads with larger size quoted on each side of the market, as locals are attracted to an active market. The liquidity of the futures market increases with the number of participants. A primary objective should be to expand the extent and frequency of market participant interaction.

However, fragmented futures markets would, in fact, reduce market participant interaction, with dire consequences for market liquidity and risk hedging.[12] As order flow and information flow are diverted to the nontransparent, noncompetitive trading arena, the frequency with which orders enter the floor market is decreased. Locals widen bid-ask spreads in order to protect themselves from increased inventory risk. Widening spreads detract from the markets' attractiveness, causing more participants to shun the floor market, which, in turn, subjects locals to further increased risk. As in price discovery, locals can react in either of two ways: withdraw from the market or further increase spreads. Either way, liquidity spirals downward.

Since order flow provides valuable information to locals, the market to which traders

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[12] The Commission acknowledged as much when it enacted Part 36. In Part 36, the Commission mandated that any "professionals only" market be a stand-alone market, not an adjunct market, to an existing regulated market. The Commission imposed such a requirement to ensure that an exempt market does not divert order flow from an established market. As the Commission has acknowledged, such a diversion would hamper the price discovery and liquidity of the established market.

submit orders becomes a crucial issue. If enough traders decide to send their orders to the noncompetitive arena, then it is the upstairs market maker who knows more about demand for futures transactions. Depending upon the extent of order flow diversion to noncompetitive markets, a downward liquidity spiral could end in the disappearance of the floor-based market with concomitant negative effects on risk hedging for small and medium-sized market participants.

E. Sound Public Policy Supports the Limitations on the Commission's Exemptive Authority Under Section 4(c)(1) of the CEA

Admittedly, the open and competitive trading requirement of the CEA is not absolute. For example, Congress has determined that market participants' ability to enter into EFPs is compatible with the general publics' interest in open and competitive futures markets. However, the EFP exemption is an expressly limited statutory exception to the principal statutory requirement that futures transactions must be traded openly and competitively on designated contract markets.

The express language of Section 4(c)(1) of the Act provides that the Commission's exemptive authority is conditional. Specifically, the exemptive authority is conditioned upon a determination by the Commission that "the exemption would be consistent with the public interest."[13]

Consequently, any modification to the open and competitive trading requirements should be approved with extreme caution. Any modification should be clearly and specifically authorized by the Commission and supported by substantial economic research that the liquidity of the related futures markets would not be endangered.

If the Commission creates another exception to the longstanding tenet that futures must be transacted openly and competitively, without thoroughly evaluating the ramifications to established, centralized markets, the public interest in open and competitive markets will be severely compromised.[14] In sum, any decision to exempt a noncompetitive transaction should

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[13] 7 U.S.C. 6(c).

[14] In their treatise on commodities regulation, Philip McBride Johnson and Thomas Lee Hazen state:

> If it could be said in ancient times that all roads lead to Rome, it is equally true today that all lawful trading in domestic futures (and most lawful trading in domestic commodity options) occurs on one of the nation's thirteen active designated contract markets. In domestic futures trading, there is no such thing as a lawful over-the-counter market. Within the past several years, however, a combination of actions by Congress, the Commission, and the courts have made that claim — accurate to a fault when written — seem naive at a minimum. A tenet of commodities regulation that was once believed to be eternal has been replaced by a patchwork of exemptions, exclusions, policy statements, statutory interpretations, and court rulings that, in the best tradition of the law, have birthed so many exceptions to the general rule as to

be based upon a determination that, at a minimum, the transaction will not have any adverse impact on the hedging and pricing functions of the futures markets.

III. The Commission Should Not Subject EFP Transactions That Are Related To Active Exchange-traded Contracts To Additional Regulation

In the Concept Release, the Commission questions whether EFPs should be subject to additional regulation. In that regard, the Commission asks whether the standards articulated in the 1987 report entitled, "Report of the Division of Trading and Markets: Exchange of Futures for Physicals" ("EFP Report"), should be codified.

For the reasons discussed below, the Exchange urges the Commission to maintain a status quo approach to the regulation of EFPs, with one exception where we believe an additional safeguard is necessary to protect against market fragmentation. This additional safeguard, which is described below in Part D, relates to EFP transactions involving a clone of an established and viable futures contract offered by another exchange.

A. EFPs Are Subject to Adequate Regulatory Oversight

The Exchange generally believes that EFPs are adequately regulated and urges the Commission to leave undisturbed the regulatory framework that is currently in place (subject to the additional standard described below in "D"). This framework not only permits flexibility in the use of EFPs, but effectively detects and deters abusive practices involving EFPs.

As the Commission is aware, EFPs have a unique statutory underpinning. Although Section 4c(a) of the Act generally prohibits the noncompetitive execution of futures contracts, the section excepts from its proscriptions the "exchange of futures in connection with cash commodity transactions or of futures for cash commodities. . . ."[15] According to the legislative history of Section 4c, Congress enacted the EFP exception to preserve an "accepted commercial practice."[16]

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threaten to overwhelm that rule. Philip M. Johnson & Thomas L. Hazen, Commodities Regulation, §102[8] at 1-41 (3rd ed. 1997.)

15 Section 4c(a) provides in relevant part:

> Nothing in this section [of the Act] shall be construed to prevent the exchange of futures in connection with cash commodity transactions or of futures for cash commodities, . . . if made in accordance with board of trade rules applying to such transaction and such rules have been approved.

16 Commodity Short Selling, H.R. Rep. No. 1551, 72d Cong., 1st Sess. 3 (1932).

While Section 4c(a) excepts EFPs from the Act, however, it is silent on the scope of the exception. Instead, Commission Regulation 1.38 provides that the only requirement of EFPs is that they be executed "in accordance with written rules of the contract market which have been submitted to and approved by the Commission. . . ."[17] Commission Regulation 1.38, therefore, provides the framework under which EFPs are regulated. Under that framework, EFPs are subject to several layers of federal and self-regulatory oversight. They include:

(I) the Commission's review of contract market rules governing such transactions;

(ii) the Commission's reporting and recordkeeping requirements;

(iii) the contract markets' enforcement of their own rules;

(iv) the Commission's rule enforcement review program; and

(v) the Commission's own enforcement program.[18]

The framework carved out by Congress and implemented by the Commission and the exchanges has provided a level of regulation that is commensurate with the needs of the EFP market. Absent a demonstrable need, the Commission should not impose additional layers of regulation in an area that has traditionally — and effectively — been handled by the exchanges with limited Commission oversight.

B. The Commission Should Continue to Permit the Exchanges to Decide In The First Instance How to Regulate and Monitor EFP Trading In Their Own Products

Pursuant to Section 4c(a) and Commission Regulation 1.38, the "responsibility for regulating EFPs lies in the first instance with the exchanges."[19] The Exchange endorses this long-held proposition because the exchanges are in the best position to assess the regulatory needs of the marketplace. In providing a structure for the execution of EFPs, the exchanges have the most immediate perspective on EFP developments. As a result, when regulatory needs develop, the exchanges are in the best position to devise regulatory responses that do not curtail lawful activity.

The Exchange notes that many of its customers share the same view. For instance, in

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17 17 C.F.R. § 1.38(a).

18 63 Fed. Reg. at 3711.

19 EFP Report at 259.

its comment letter on the Commission's Concept Release, the National Grain Trade Council — a trade association composed of grain companies, boards of trade and grain marketing organizations — notes that "exchanges are most closely connected with the evolution of the marketplace and best positioned to monitor these transactions."[20]

As front-line regulators, the exchanges have successfully regulated EFP transactions. In fulfilling their statutory mandate, the exchanges have implemented rules and developed comprehensive surveillance programs to regulate EFP transactions.

At the CBOT, for example, surveillance of EFPs is conducted by the Office of Investigations and Audits ("OIA"). In conducting surveillance, OIA seeks to ensure that EFPs are executed in accordance with Exchange Regulations 444.01 and 444.02 and Commission-approved Floor Notices.

Specifically, OIA seeks to ensure compliance through several programs, which include:

1. A member-firm audit program, in which OIA biennially reviews select EFP transactions of FCMs to determine whether they are bona fide.

2. An "Exchange for Physicals Surveillance Program," which includes a computer database that allows OIA to target EFPs that possess certain characteristics, such as executions outside of a day's trading range, after trading in a specific contract has ceased, or between two clearing firms in a particular commodity at the same price and quantity.

3. An investigative and disciplinary program, in which OIA investigates alleged EFP abuses and, where appropriate, refers matters to an Exchange disciplinary committee. (In 1997, OIA referred ten EFP related matters to a disciplinary committee. In each case, the disciplinary committee issued charges and the matter was ultimately settled. The cases involved either non bona fide transactions, transactions in which the quantity of futures exchanged for the physical was not equivalent, or multi-party transactions.)

The Exchange's surveillance and enforcement efforts, coupled with limited Commission oversight, have provided market participants with the level of security and flexibility they demand. Perhaps most telling, however, is that the users of EFPs — our customers — have told us that they not only believe in the efficiency of the EFP market, but are confident of the safeguards that are currently in effect.

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[20] See Letter from Robert Petersen, President, National Grain Trade Council, to Jean A. Webb, Secretary of the Commission (Apr. 27, 1998).

C. The Commission Should Continue Its Vigilant Enforcement of Non Bona-Fide EFP Transactions

The Exchange fully supports vigilant Commission and Exchange enforcement of extant EFP regulations, particularly with respect to transitory, or "sham," EFPs. The Exchange shares the Commission's view that since sham transactions involve only a transitory change in ownership of the cash commodity, they are not EFPs — they are illegal off-exchange futures transactions. As a result, the parties to such transactions should be prosecuted.

D. Proposed Safeguard Against Market Fragmentation

There is one area where the Exchange believes the Commission should adopt an additional safeguard. In the Exchange's view, the Commission should not permit an exchange to adopt rules allowing EFP transactions involving a futures contract that clones an active, established, futures contract offered by another exchange unless and until the clone contract becomes established as a successful and viable contract on its own merits. This precaution is necessary to protect against market fragmentation and the resultant harm that would occur to the price discovery and hedging benefits of established auction markets.

There may be different ways to measure whether the clone contract is "successful and viable" on its own, independent of any EFP transactions (or other noncompetitive transactions[21]). We would recommend a standard based on average daily trading volume. If a clone futures contract can sustain an average daily trading volume of 5,000 contracts on a rolling twelve-month basis, the contract would be considered successful and viable.

We encourage the Commission to adopt the safeguard we propose.[22] Otherwise, the Commission would effectively allow alternative, non-competitive EFP markets to drain liquidity from centralized auction markets, to the detriment of market users who depend on this liquidity and price transparency. In this regard, the standard we propose is consistent with our longstanding position that EFP transactions should be allowed only if they do not damage the liquidity and efficiency of the centralized futures markets.

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[21] A clone contract market should have to meet these tests without the benefit of block trading or other noncompetitive trading practices that could provide an unfair competitive advantage over the active, established contract market and draw liquidity away from that market.

[22] We urge the Commission to apply this standard to the pending application of the Cantor Financial Futures Exchange ("CFFE") for designation as a contract market in various Treasury futures contracts that are nearly exact replicas of the Exchange's Treasury contracts. The CFFE is proposing to allow EFP transactions in its copycat contracts. As explained in the Exchange's separate comment letter on the CFFE application, the Exchange has serious questions about whether the CFFE is seeking to accommodate large block trading of the Exchange's Treasury security futures through the EFP mechanism.

E. No New Regulation is Needed for Execution Facilities for EFPs

The Commission has asked whether it should adopt special requirements for execution facilities for EFP transactions, including whether such facilities should be regulated as designated contract markets. The Exchange vehemently opposes the adoption of any special regulatory structure for execution facilities for EFPs.

As explained in the preceding sections, EFPs are already subject to adequate regulation. The Commission has not cited any special problems with execution facilities that warrant a higher degree of regulation for EFP transactions that occur on such facilities. In our view, the only relevant considerations are the same ones cited above, including most notably, the proscription against transitory EFPs and a prohibition against EFP transactions involving copycat contracts that are not successful and viable on their own merits. Certainly, if an execution facility permits or encourages transitory EFPs, it is operating as a contract market for the futures component of the transactions and should be regulated as such. There is, however, no statutory basis for regulating a trading system for EFP transactions as designated contract markets so long as the EFPs are bona fide and retain their true economic character as EFPs.

The Exchange is troubled that the Commission singles out our plans to offer an electronic market for Treasury basis trades on Chicago Board Brokerage, LLC ("CBB") for special attention in the Concept Release. CBB is a registered government securities dealer under the federal securities laws. CBB has received a no-action ruling from the Securities and Exchange Commission to offer electronic trading of government securities and related products, including the basis trade. The basis trade product is a form of EFP involving an exchange of a CBOT Treasury futures contract for a cash position in the related government security. The Exchange questions why the Commission is raising possible issues regarding CBB now, on the eve of CBB's plans to launch its electronic trading, when the Commission has known for years about the CBOT's plans.

F. The Commission Should Not Codify the EFP Report

For many of the reasons noted above, the Commission should not codify the EFP Report. Significantly, the Exchange's position is consistent with the position taken by the Division of Trading and Markets ("Division") in the EFP Report. In that report, the Division stated that EFP regulation should be subject to a:

> flexible approach, which recognizes the variety of uses for EFPs across the different markets, [and] will enable the exchanges to adapt the Division's analysis to the particular circumstances of their markets, either by rule or through their affirmative surveillance programs. The Division recognizes that EFP practices continue to evolve to accomplish a variety of trading strategies

and industry needs as the nature of the futures market changes.[23]

Today, as much as in 1987, a "flexible approach" is warranted.

The Exchange notes that others who have commented on the Commission's Concept Release share the same view as the Exchange and the Division. For example, The Bond Market Association states in its comment letter that "[c]odifying the EFP Report would defeat its long-standing value as a flexible, adaptable tool for the market participants."[24]

The efforts of the exchanges, coupled with Commission oversight and enforcement, have provided an appropriate level of regulation. At the same time, the exchanges and the Commission have allowed EFPs to evolve with the needs of the marketplace. The adage, if it's not broken, don't fix it," could not be more apt.

IV. The Commission Should Exempt EOPs and EFSs From the Open and Competitive Trading Requirements of the CEA Only Upon a Finding That Such Noncompetitive Transactions Do Not Adversely Impact the Liquidity of Futures Markets.

In the event that the Commission determines to exempt "exchange of futures options for physicals" ("EOPs") and the "exchange of futures for swaps" ("EFSs") from the open and competitive trading requirements of the CEA, the Commission's exemption should be pursuant to a pilot program similar to the CBOT-proposed pilot program referred to in the Concept Release.

As the Commission is aware, the primary purpose of the Exchange's one-year pilot program was to gather information that would enable the Exchange to learn, as a matter of fact, that the proposed transaction did not have any negative impact on the liquidity of the related futures markets.

The CBOT's proposal referenced in the Concept Release requested authorization of a transaction that would have allowed qualified parties to exchange a position in agricultural futures contracts for a hybrid, over-the-counter agricultural option position. The specific terms of the proposed pilot program required that:

1) the futures and over-the-counter options components be integrally related;

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[23] EFP Report at 260.

[24] See Letter from Paul Saltzman, Esq., Senior Vice President and General Counsel, BMA, to Jean A. Webb, Secretary of the Commission (Apr. 1, 1998).

2) there be a reasonable correlation in terms of price, quantity and duration between the futures contracts and over-the-counter options;

3) the transaction be effected between two separate parties;

4) the offeree of the over-the-counter option must be authorized by the CBOT; and

5) because of the existing agricultural trade option ban, the offeree of the over-the-counter option must be a foreign commercial entity (unless the entity has received "no action" relief regarding the agricultural trade option ban) and must enter into the transaction solely for purposes of managing risk associated with its business.

Eligibility for the CBOT's proposed program also required the participants to agree to:

1) comply with all relevant legal and regulatory requirements relating to the offer and sale of over-the-counter agricultural options;

2) continually hedge market exposure from the sale or purchase of the over-the-counter options through the use of exchange-traded futures and options contracts (the products covered by the program would include all agricultural commodities for which there is a corresponding futures contract listed on the CBOT);

3) after the execution of each transaction, provide the CBOT with detailed information (on a confidential basis) regarding the futures contract and over-the-counter options; and

4) provide the CBOT, on a quarterly basis, with statistics of the CBOT hedging volume related to the transaction.

Pursuant to the proposal, continuance of the program would depend on finding that, at a minimum, there had not been any adverse impact on the hedging and pricing functions of designated markets.

The CBOT submitted its proposal based on the belief that the transactions had the potential to increase the use and efficiency of the related futures and futures options markets. However, because the CBOT lacked the substantive economic data to determine the proposal's impact on its futures markets, the CBOT proposed the program on a strict pilot basis.

Similarly, the NYMEX has submitted an EFS proposal that it believes would "facilitate greater usage of NYMEX as a centralized market."[25] To date, the CBOT is unaware of any substantive economic research that would establish that the NYMEX's proposed EFS transactions would, in fact, enhance the use of its related futures contracts.

Therefore, if the Commission contemplates exempting the NYMEX's proposed EFS transaction or any other noncompetitive transaction, the CBOT recommends that any such exemption should be granted on a strict pilot program basis that would allow for a determination of the transactions impact on the futures markets.

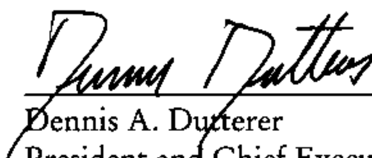
V. Conclusion

The Exchange respectfully reminds the Commission that its primary purpose and its statutory obligation is to promote and preserve open and competitive futures markets — markets that foster liquidity and facilitate reliable price discovery and effective risk management.

Accordingly, any Commission determination to exempt a noncompetitive transaction from open and competitive trading requirements should depend on a finding that, at a minimum, there is no adverse impact on the hedging and pricing functions of the designated futures markets.

Sincerely,

Thomas R. Donovan
President and Chief Executive Officer
Chicago Board of Trade



Dennis A. Dutterer
President and Chief Executive Officer
Board of Trade Clearing Corporation

cc: The Honorable Brooksley Born, Esq.
The Honorable John E. Tull, Jr.
The Honorable Barbara Petersen Holum
The Honorable David S. Spears
Mr. I. Michael Greenberger, Director, Division of Trading and Markets

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[25] 63 Fed. Reg. at 3715.