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CFTC

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COMMENT

April 28, 1998

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 - 21st Street N.W.
Washington, D.C. 20581

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

COMMODITY FUTURES
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Dear Ms. Webb:

The Concept Release includes 57 separate questions, several with subparts. The multitude of questions stems from the implicit assumption that the classes of off-exchange transactions described by the Release may require separate regulatory treatment. The CME disagrees with this approach. With the exception of one small class of EFPs, all transactions described by the Release are economically equivalent and present identical regulatory issues.

The distinct class of EFPs is those that involve delivery of nonconforming commodity to satisfy a futures position, i.e., EFPs that liquidate open interest. Those EFPs should be freely permitted, subject to the rules of the relevant contract market. For purposes of this discussion, the "physical" portion of the EFP may include a swap or an option depending on the underlying deliverable. In the case of liquidating EFPs, the original futures position was established by open outcry and contributed to liquidity and transparency of the market. The substitution of a nonconforming deliverable does not affect liquidity or defeat expectations of other market participants who knew the rules in advance. In the case of liquidating EFPs, nothing happens in a non-competitive transaction that would not have occurred if delivery had been completed or if the contract had been cash settled.

All other EFPs, EFSs, EFOs, and every other species of off-exchange trading of futures contracts are indistinguishable and should be treated alike. Each of these transactions may divert trading from the central marketplace. Off-exchange futures trading deprives the market of the real time information that would have been generated by those transactions. An imbalance between the volume of transparent centralized futures trading and off-exchange trading of those same contracts can impose very substantial costs.

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Off-exchange trading has the potential to weaken the primary market as a legitimate price discovery venue, to raise the cost of users without access to the OTC futures market, and to impair the risk transfer and hedging functions that justify futures markets and their federal regulators.

In addition to the questions regarding off-exchange futures trading, Questions 47 through 57 focus on the appropriate treatment of certain execution facilities that trade or that are planning to trade futures contracts without seeking designation as a contract market by the Commission. The Release acknowledges that the Commission has permitted unregulated futures markets to buy and sell futures contracts if traded in combination with a cash instrument and if a designated contract market sanctions the transaction.

The CFTC lists Cantor Fitzgerald, Liberty, RMJ, Tullet & Tokyo, Garban, and Hillard & Farber as the six major interdealer brokers that offer basis-trading facilities. Chicago Board Brokerage, the CBT's SEC-registered broker/dealer is planning to operate a basis trading facility without designation by the CFTC. The most cursory review of the operations of the interdealer brokers unequivocally demonstrates that they are operating boards of trade and trading contracts of sale for future delivery. There is nothing in the Commodity Exchange Act that legitimizes operating an undesignated contract market. Simply put, the CFTC is not enforcing its statute.

The Commission has not exempted interdealer brokers that are operating a futures exchange from registration. We can be confident that the Commission would not permit an unregulated Treasury Bond basis trading pit on the floor of the CBT or on Project A. Yet the trading rooms of the interdealer brokers operate exactly like trading pits on the floors of traditional exchanges except the interdealer brokers lack real transparency and clear audit trails. There is no logical basis for an exemption in favor of the interdealer brokers unless the CME and other futures exchanges are granted an equal exemption for their electronic trading system and any floor operation that involves a combination cash and futures trade.

The first three questions posed by the Release are the questions that demand the most attention:

- (1) *Should the standards articulated in the EFP Report be codified in the Commission's regulations and/or refined in any way?*

EFPs that do not liquidate competitively established futures positions should be subject to the same constraints as all other off-exchange futures transactions. Questions 4 through 23 need not be answered separately if this proposition is accepted. All OTC futures transactions that are permitted by the Commission on the ground that those transactions are

subject to the rules of a designated contract market should be subject to the same federal requirements. (See answer to Question 2, below.)

- (2) *Should other types of noncompetitive transactions, such as EFS transactions or block trades, be permitted to be executed on or subject to the rules of a contract market and, if so, what standards should apply to these transactions?*

Off-exchange futures trading adds risks for the participants and for the underlying market. The veracity of the price discovery function depends on incorporating the information of informed traders into the pricing matrix. Unreported or late reported upstairs trades are counterproductive. Sustaining the necessary liquidity for cost effective hedging depends on concentrating trade at a focal point. Finally, an increased risk of manipulation must be considered if large transactions can be accomplished without direct scrutiny of the market regulators.

The non-dealer customer, who transacts away from the market, is subject to a number of additional individual risks. First, he will frequently be dealing principal-to-principal with a firm that usually serves him as agent. Whereas the customer expects the counterparty to be serving the customer's best interest, the counterparty is intent on serving its own. This confusion, sometimes fostered by the counterparty, seems to have been at the heart of several of the recent swaps scandals.

Second, the non-dealer customer will frequently be at a substantial information disadvantage. Numerous forms of customer abuse, from fraud to front running to mispricing, are more easily accomplished in the privacy of a back office.

The Commission's Release clearly acknowledges the importance of these concepts.

"Both the Commodity Exchange Act and the rules and regulations of the commodity exchanges require that futures transactions be executed openly in a competitive manner. Certain carefully prescribed exceptions to competitive trading are allowed, but they do not nullify the general requirement of open and competitive trading. 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. (Citing Report of the Senate Committee on Agriculture and Forestry, S. Rep. No. 1131, 93rd Cong., 2d Sess. 16 (1974).)

"Consistent with this policy, Commission Regulation 1.38(a) requires that contract market rules providing for the execution of noncompetitive transactions must be submitted to the Commission for approval. Commission Regulation 1.38(b) requires all noncompetitive

transactions as well as all related orders, records, and memoranda to be identified and marked. Regulation 1.38 was adopted pursuant to Sections 4b and 8a(5) of the Act. Section 8a(5) authorizes the Commission to "make and promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of this Act."

The CME agrees with the Commission's suggestion that a contract market seeking approval of noncompetitive trading procedures should "address the effect of the proposal on the contract market's usefulness as a vehicle for price discovery and risk transfer." It is not enough, however, to look at the impact on the market proposing the rule. If that market is not the principal futures market for the underlying product, the test must be whether the principal market is adversely affected. Otherwise, internet exchanges can easily be established for the sole purpose of passing rules to permit upstairs trading that will drain liquidity from the true competitive marketplace.

The CME also believes that a contract market seeking approval for such transactions ought to be required to clearly demonstrate that its ability to detect and deter manipulations will not be adversely affected. The CME also agrees with the Commission that the market should be required to demonstrate that "its proposal was the least anticompetitive means of achieving its objective." If "large order execution rules," "all-or-none," "requests-for-quotes," or similar methods of bringing large or unusual orders to the central market work, noncompetitive trades should be discouraged.

Finally, the CME believes it is essential that a contract market seeking to authorize upstairs trading demonstrate that the transactions it seeks to authorize will, in the Commission's words, "complement the competitive market, not supplant it. The CME accepts the Commission's suggestion that properly administered and carefully circumscribed rules "might improve the usefulness and efficiency of existing markets for institutional or professional users but with a reduced risk of market fragmentation."

A designated contract market that conducts the principal auction market for the derivative contract has the correct incentive to properly gauge the impact of rules permitting noncompetitive trading on the underlying market. It is the market that has the strongest interest in insuring that such trading does not increase the potential for manipulative activity. Only those designated contract markets with a substantial share of competitive trading should be enabled to permit off-exchange trading of their products, and then to the limited extent that those OTC futures do not undermine the price discovery function and liquidity of the auction market.

- (3) *What standards should be applicable to execution facilities for noncompetitive transactions executed on or subject to the rules of a contract market?*

An execution facility that allows its participants to trade futures contracts, alone or in combination with physical commodities, is a contract market and should be subject to the same designation standards applied to an execution facility, like GLOBEX® or like the trading pits of the designated contract markets. Nothing in the CEA or in any existing Commission regulation exempts a board of trade that uses its facilities to trade "contracts of sale for future delivery" from the designation requirement of the CEA. The provision that permits EFPs to be done ex-pit does not permit a board of trade that is trading futures contracts in combination with cash to escape regulation. The EFP exemption applies to the contract not to a separate futures exchange that trades the contract.

Any other interpretation leads to the odd result that only one exchange needs to seek designation from and subject itself to regulation by the Commission. Since clever financial engineers can reconstruct all important futures contracts as basis trades, the designated contract market can sponsor a host of unregistered exchanges to trade EFP-like contracts. The EFP exchanges could then operate subject to rules of the designated contract market without registration or direct supervision by the CFTC. But, that would clearly conflict with the pattern of self-regulation prescribed by the CEA. The self-regulatory duty of each contract market is to supervise the conduct of its members, not to regulate satellite exchanges to which all of the real trading has been transferred.

Unless the Commission is prepared to permit the Chicago Mercantile Exchange to elect to escape CFTC jurisdiction for all cash vs. futures basis trades, it may not afford other exchanges more favorable treatment. Questions 47 through 57 are all answered by reference to the conclusion that execution facilities through which futures contracts are bought and sold must be registered contract markets.

Sincerely,



T. Eric Kilcollin
President and Chief Executive Officer