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Chicago Board of Trade

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Thomas R. Donovan
President and
Chief Executive Officer

1998 SEP -2 A 11 3

September 1, 1998

COMMENT

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
63 Federal Register 3708 (Jan. 25, 1998) ("Concept Release")**

Dear Ms. Webb:

The Commodity Futures Trading Commission ("CFTC" or "Commission"), through the above-referenced Concept Release, has initiated a broad policy review of its current regulation of noncompetitive transactions on or subject to the rules of a contract market. As part of this reevaluation, the Commission is exploring whether to expand the narrow range of noncompetitive practices currently allowed. The Chicago Board of Trade ("CBOT" or "Exchange") has long opposed any such expansion based on concerns that block trading or other noncompetitive practices could divert order flow from the centralized competitive futures markets, thereby jeopardizing the price discovery and hedging benefits they provide and which Congress has found to be in the national public interest. These concerns underlie, in large measure, the CBOT's objections to the proposed Cantor Financial Futures Exchange ("Cantor Exchange"), which, if approved in its current form, would offer a block trading facility for futures contracts that largely replicate some of the most successful contracts now offered by the CBOT and in contravention of current CFTC requirements for open and competitive trading.

Although the CBOT believes our objections to noncompetitive trading practices are well-founded in economic principles, we decided to test them under current market conditions by commissioning an expert study on the consequences of such practices on centralized competitive exchange markets. The CBOT retained Professor Haim Mendelson, a chaired professor at Stanford Graduate School of Business, and Professor Yakov Amihud, a professor at the Stern School of Business, New York University, to conduct this study. Professors Mendelson and Amihud have drawn upon their extensive prior scholarship and research on trading markets and market fragmentation in conducting their evaluation.

The CBOT has enclosed a copy of Professor Mendelson and Amihud's final report, entitled "Evaluation of Alternative Execution Procedures in Futures Markets" (the "Report"), as our

comprehensive response to the block trading portion of the Concept Release.¹ In the Report, Professors Mendelson and Amihud provide an economic framework for evaluating "alternative execution procedures" for exchange futures markets. Their findings and conclusions underscore the need for the Commission to proceed cautiously in considering any relaxation of the narrowly prescribed limits on noncompetitive trading that exist today in order to avoid the introduction of trading practices that could fragment the futures markets by diverting order flow from the centralized competitive markets. In that regard, Professors Mendelson and Amihud confirm that Congress was correct to base the Commodity Exchange Act on the core principle that open and competitive centralized futures trading is essential to serving the national public interest in efficient price discovery and risk management.

Professors Mendelson and Amihud also examined, as a case study, the Cantor Exchange's proposed block trading procedures under the evaluative framework they propose. Notably, their analysis confirms that the Cantor Exchange's block trading features will likely harm the liquidity and price discovery of markets which currently operate on open and competitive trading principles and whose contracts CFFE seeks to emulate. (See Section III below.) We ask the Commission to consider the Report and our comments in this letter in its deliberations on the Cantor Exchange application given their direct relevance to those deliberations, and to accept the Report and this letter also as part of the public record in that proceeding.

The CBOT is in the process of reviewing the Report and its implications. Pending completion of our review, we offer the following general comments on the Concept Release.

I. Relaxing Noncompetitive Trading Restrictions Is Not the Answer To ProMarket

The Commission has offered the following explanation as one reason for issuing the Concept Release:

"Finally, recent legislative proposals contemplate the establishment of separate, professional markets. The Commission wishes to explore whether it is possible to achieve some of the objectives of these proposals by expanding the boundaries of permissible noncompetitive trading on existing contract markets. In contrast to the legislative proposals, a revised structure governing noncompetitive transactions could

¹ The Report and this comment letter focus on the block trading issues. They supplement the CBOT's April 27, 1998 comment letter, which discusses the role and value of centralized, competitive exchange markets in promoting price discovery and efficient hedging and responds to the Commission's specific questions regarding exchange of futures for physicals and proposed variations of those recognized, limited exceptions from competitive trading requirements (i.e., the CBOT's proposed exchange of options for physicals and the NYMEX's proposed exchange of futures for swaps).

act as an adjunct rather than as an alternative to existing regulated markets. Such an approach might improve the usefulness and efficiency of existing markets for institutional or professional users but with a reduced risk of market fragmentation. Thus, carefully designed revisions to the regulatory structure governing noncompetitive transactions could have a procompetitive effect.” (63 Fed. Reg. 3710).

We disagree with the Commission’s suggestion that giving exchanges the added flexibility to permit noncompetitive trading on existing contract markets is an adequate response to the exchanges’ past demands for regulatory relief for professionals only markets. Our calls for legislative reform go well beyond trading practices. If the Commission is serious about wanting to enhance the competitiveness of the U.S. exchanges, then it should work with the exchanges to fashion a more comprehensive exemptive framework either through Commission rulemaking and exemptive action to replace the wholly-inadequate Part 36 Rules or through legislative initiatives. By focusing piecemeal on trading practices as one area to relax regulatory standards, the Commission has ignored the broad thrust of the exchanges’ reform efforts and continues to deny the exchanges the flexibility to determine for ourselves where relief is most appropriate for professional market users. In fact, most of the exchange comment letters submitted through July generally oppose expansion of noncompetitive trading practices.

Moreover, we question whether allowing new types of noncompetitive trading practices for existing contract markets, as contemplated, will have the intended “procompetitive effect.” To the contrary, such flexibility could well cause widespread deterioration in the quality of the contract markets offered by U.S. futures exchanges, and hence the competitiveness of those markets in the global arena, if exchanges are allowed to poach one another’s successful contracts with the enticement of noncompetitive block trading mechanisms. If the Commission decides to pursue initiatives to expand the permissible range of noncompetitive trading practices, it should incorporate limitations to protect established markets against unfair competition from other exchanges offering their contracts under less stringent trading standards, and the consequent harm to market quality that will likely occur through market fragmentation. The Commission found this to be an important principle in fashioning exemptive rules for exchange markets and made it a formal condition in the final Part 36 Rules. The findings in the Report demonstrate the wisdom of that requirement.

II. The Report Confirms that the Commission Should Proceed Cautiously

Historically, the Commission has approached noncompetitive trading cautiously, reflecting the CEA’s underlying premise that noncompetitive practices detract from the price discovery and hedging functions of the futures markets. The Commission expressly acknowledges in the Concept Release that noncompetitive block trading “potentially raises concerns, including, among others: the impact on price discovery; the impact on liquidity; [and] the potential for manipulation.” (63 Fed.

Reg. 3718) The Commission also recognizes that any form of alternative transaction execution mechanism creates a "risk of market fragmentation." (63 Fcd. Reg. 3710, see quote in Section I.)

Thus, the Commission has in the past sanctioned only a narrow range of noncompetitive practices for exchange markets. Existing exchange crossing rules allow orders to be matched but only after providing other market participants an opportunity to participate in the trade. As the Commission notes, these Commission-approved rules "generally preserve the competitive forces available on a centralized market and thereby comply with the 'open and competitive' requirement of Commission Regulation 1.38(a)." (63 Fcd. Reg. 3716)

The Report confirms the validity of the economic principles which underlie the open and competitive trading requirements for futures markets. Noncompetitive trading practices that divert certain trades from interacting with the full order flow will likely fragment the futures markets, resulting in decreased liquidity, wider bid-ask spreads and harm to market integrity. Balancing the market fragmentation risks against the potential benefits of block trading, the CBOT has concluded that the market fragmentation risk is too great and the claimed benefits of block trading too meager to permit those practices in our markets. The Report adds important evidence supporting that decision. For example, the Report confirms that the CBOT's members today regularly accommodate orders of considerable size through our liquid open-outcry pits. Thus, the need for alternative execution mechanisms for such orders is unproven, at best.

Based on the findings in the Report, the CBOT opposes any change to the regulatory structure that would expand the range of permissible noncompetitive trading practices. If the Commission decides to entertain such proposals, however, it should proceed cautiously under an established regulatory framework. The Commission in establishing such a framework should balance the purported benefits of proposed alternative execution procedures against the harmful effects on market liquidity, price discovery and market integrity that could be caused by market fragmentation through splitting of order flow.

Additionally, if multiple exchanges trade or propose to trade the same or similar contracts, the Commission should allow only the exchange with the principal market to adopt alternative execution procedures. This restriction is necessary to protect the principal competitive market against unfair competition from another exchange "free riding" on the principal exchange's successful contract design by offering a copycat contract and seeking to attract liquidity through the lure of noncompetitive trading practices. As the Chicago Mercantile Exchange stated in its April 28, 1998 comment letter on the Concept Release, when a market seeks to offer noncompetitive trading practices on the principal exchange's market, "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." We agree with the CME's position.

III. The Proposed Cantor Exchange is a Block Trading Facility

The Report confirms that the proposed Cantor Exchange is designed as a noncompetitive block trading network in the CBOT's Treasury futures contracts. (See Section E.1 of the Report.) Professors Mendelson and Amihud confirm that "the core of the CFFE's trading system is an [Alternative Execution Procedure] that sacrifices the principle of an open and competitive marketplace by facilitating a 'workup' process similar to that used to facilitate block trades in the cash market for U.S. Treasury Securities." (Report, p. 1) The Report also identifies two other proposed noncompetitive trading mechanisms at the Cantor Exchange which futures exchanges are currently not allowed to accommodate: crossing of trades at randomly determined prices and transitory EFPs.²

Inexplicably, however, the Commission staff has yet to provide any clear indication in the public record that it recognizes that the Cantor Exchange is designed as a block trading facility. The Report should put any doubts to rest. As the Report explains, the Exclusive Time procedures are carefully designed to facilitate execution of large futures orders at a single price through a bilateral "work-up" mechanism. During the work-up negotiations, all other market participants and all superior bids or offers that would otherwise be available *are excluded* as the parties with exclusive trading rights decide during a string of successive Exclusive Time periods³ whether to trade additional quantities with one another at the locked trade price. These are the same type of block trading procedures that Cantor Fitzgerald⁴ uses today as an interdealer broker for U.S. Treasury Securities.

Furthermore, the Cantor Exchange would seem to fit the Commission's example of a "computerized, bulletin board system [that] might be established in connection with the execution of blocks" *if* "the Commission were to permit other types of noncompetitive trading." (63 Fed. Reg. 3720) The view-

² The New York Cotton Exchange, one of the sponsors of the Cantor Exchange, suggests in its April 27, 1998 comment letter on the Concept Release that transitory and contingent EFPs are currently permissible. On page 3, the letter states "As long as the cash leg is bona fide, transitory EFPs should continue to be accepted." See also the statement on page 5 that "Regulation to halt contingent ABA trades sometimes run contrary to cash market conventions that have been designed to reduce risk as well as the costs of doing business." These statements hint at the Cantor Exchange's plans to allow transitory EFPs as a mechanism to trade outright futures contracts noncompetitively, contrary to our understanding of the Commission's interpretation of a bona fide EFP.

³ The duration of the Exclusive Time period is not fixed in the Cantor Exchange rules. Rather, it is left to the discretion of an exchange committee. The application materials state that initially the Exclusive Time period will be six seconds. Cantor Exchange Rule 315 indicates that trading could be locked at a given price through a series of successive Exclusive Time periods for as long as five minutes.

⁴ All Terminal Operators on the Cantor Exchange will be employees of and assigned by Cantor Fitzgerald.

only screens that customers will receive serve to attract trading interest. The Terminal Operators can also call customers to solicit trading interest and will stay on the telephone with the customers involved in a work-up to intermediate the negotiated trading process. In short, block trading will occur on the Cantor Exchange through one-on-one negotiations "above" or "over" the Cantor Exchange screens, and not through consolidation and interaction of all orders on the electronic system.

The Commission should suspend its consideration of the Cantor Exchange application until it completes the review of block trading under the Concept Release and adopts an appropriate regulatory framework for evaluation and oversight of any new types of noncompetitive practices the Commission may ultimately decide to allow. This course of action is dictated by the Commission's statement in the Concept Release indicating that "*After* reviewing the comments, the Commission will determine whether rulemaking or other action is appropriate." (63 Fed. Reg. 3720, emphasis added.) If the Commission does not defer acting upon the Cantor Exchange application, it will prejudice the difficult policy issues regarding block trading facilities on which it has sought comment and will engage in de facto rulemaking by setting new, unprecedented standards for noncompetitive trading through the contract designation process without following appropriate rulemaking procedures.

In any event, the Report demonstrates that the Commission should not change its current regulatory structure to allow the Cantor Exchange's proposed noncompetitive block trading procedures. If approved, the Cantor Exchange's block trading facility will likely cause significant harm to the CBOT's Treasury futures complex which is relied upon by the Treasury Department to help manage the public debt and stabilize interest rates and by businesses around the world to hedge interest rate exposures. As Professors Mendelson and Amihud state:

"In evaluating the CFFE, we find it is likely to fragment the market for futures on U.S. Treasury Securities. We expect this will hurt liquidity and increase bid-ask spreads and search and delay costs. Because the CFFE will allow large orders to 'trade through' superior bids or offers, market integrity and price discovery will be harmed. Further, the CFFE's trading rules discriminate against small orders, harming liquidity and market integrity. In addition, the system is unlikely to function well in turbulent times given its sequential execution procedures and the possibility that large orders will tie it up. We expect, however, that if the CBOT loses significant order flow, it will not have the liquidity to serve as a 'market of last resort' in times of stress or CFFE malfunction.

We expect the consequences of approving the CFFE application at this time to be a relaxation of market-wide trading standards, the possible loss of substantial order flow by the CBOT, a less liquid market for futures on U.S. Treasury Securities, less

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efficient price discovery, and increased cost of hedging U.S. Treasury Securities and a higher cost of debt for the U.S. Government.” (Report, p. 3)

Conclusion

For many decades, Congress and the Commission have required futures contracts to be traded on centralized markets in an open and competitive manner. That form of trading has served well the national public interests of accurate price discovery and efficient risk management. As illustrated by the Cantor Exchange case study analyzed in the Report, block trading and other forms of noncompetitive trading would threaten the ability of existing markets to continue to serve those public interests. In the absence of a persuasive showing of an overriding need for block trading facilities, the Commission should not change the fundamental precepts of the CEA and Commission regulations. If changes are to be made to that standard, perhaps Congress should address the matter in the next Commission reauthorization process.

Sincerely,

A handwritten signature in black ink that reads "Thomas R. Donovan". The signature is written in a cursive, slightly slanted style.

Thomas R. Donovan