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Chicago Board of Trade

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President and
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COMMENT

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June 29, 1999

The Honorable David D. Spears
Acting Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: CFTC Advisory on Alternative Execution, or Block Trading, Procedures for the Futures Industry

Dear Acting Chairman Spears:

On June 7, 1999 the Commodity Futures Trading Commission ("CFTC" or "Commission") issued an "Advisory on Alternative Execution, or Block Trading, Procedures for the Futures Industry "("Advisory"). That Advisory followed up on the Commission's Concept Release concerning the Regulation of Noncompetitive Transactions executed on or Subject to the Rules of a Contract Market (63 FR 3708 January 26, 1998) ("Concept Release"). In it, the Commission announced its intention to consider contract market proposals to adopt alternative execution, or block trading procedures, for large size or other type of orders on a case-by-case basis under a "flexible approach to the requirements of the Commodity Exchange Act and the Commission's regulations."

After providing a very general summary of the issue and the CFTC's experience and authority, the Advisory outlines issues which contract markets should address in seeking Commission approval of particular alternative execution procedures and urges contract markets to consult with various interested parties in developing such proposals. It does not, however, describe the process that the Commission will use in considering contract market proposals. Instead it states: "Based on its experience in reviewing contract market proposals for alternative execution procedures, the Commission will determine whether any further Commission action is appropriate." It also states that "the Commission remains open to further written comments on the various topics surrounding potential alternative execution procedures."

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<u>Previous Comments</u>:

The Chicago Board of Trade ("CBOT") submitted comments to the CFTC on April 27, 1998 and September 1, 1998 in response to the Concept Release and the two-part nature of the public comment process the Commission adopted for these issues. Both of those comment letters focused strongly on the importance of liquidity to the success of any futures market and the resulting need to document economically the potential impact of any proposed alternative execution or block trading procedures on that market's liquidity to avoid jeopardizing the price discovery and hedging benefits a well-functioning and competitive futures market provides.

The September 1, 1998 comment letter transmitted a CBOT-commissioned expert report on the potential consequences of block trading and other non-competitive 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 undertake an "Evaluation of Alternative Execution Procedures in Futures Markets" ("Report") because of their extensive prior research and experience with trading markets.

Their Report analyzed three existing examples of alternative execution procedures as well as provided an economic framework for evaluating the possible effects and appropriate standards to use when considering such procedures. The authors highlighted the importance of balancing the possible benefits of a proposed alternative execution procedure against the potential for harming market liquidity, price discovery and market integrity due to market fragmentation that can occur from splitting order flow. They specifically warn that "market fragmentation reduces liquidity and increases overall trading costs, hampers price discovery and reduces the incentive to provide information to the market." They believe that the impact of market fragmentation on the quality of trading markets should be the key consideration in evaluating any proposal, using liquidity, informational efficiency and price discovery, market integrity and product innovation as the critical characteristics to be measured. Indeed, such fragmentation has recently become an issue in the securities markets, cited by the Commission in both its Concept Release and Advisory as a successful example of utilizing block trading. (See attached *Wall St. Journal* article, "Structure Problems: Fragmented Nasdaq May Become Vulnerable to Competition.")

The CBOT believes that any Commission determination regarding the appropriateness of non-competitive execution procedures should be strictly supported by significant and substantial economic evidence establishing that the procedure will not damage the liquidity and efficiency of any <u>related</u> futures market.

This concern was well described by the Chicago Mercantile Exchange in its April 28, 1998 comment letter on the Concept Release. It pointed out that when a market seeks to offer noncompetitive trading practices for a product where another exchange already provides a principal 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." The CBOT Report also focused extensively on this potential problem.

Recommended Process:

As the Commission noted in its Advisory, the response to the block trading portion of its Concept Release was extensive but revealed two very divergent viewpoints. The Commission specifically points out that only 11 commenters generally supported expanding the use of such procedures while 49 generally opposed them. "Given the lack of consensus," the Commission advises the industry that it "has decided to evaluate such procedures on a case-by-case basis," allowing each contract market to "develop procedures that reflect the particular characteristics and needs of its individual markets and market participants."

Since the Commission has recognized the uniqueness of individual contract markets, we urge the agency to provide an appropriate analytical framework to document the pros and cons of allowing alternative execution procedures. That framework must also necessarily look at the marketplace as a whole, including consideration of the adverse consequences potentially created by copycat contracts for users of the originating exchange's contracts. The Commission should also heed its own suggestion "to solicit the input of, and coordinate with, various interested parties" by publishing for public comment any proposals to permit alternative execution procedures. The Commission will, in that way, be able to get the benefit of additional analysis of such proposals by knowledgeable members of the futures industry. While the CFTC has not identified the standards to be used in evaluating such proposals, the CBOT would strongly encourage the Commission to utilize the guidelines and background included in the CBOT-commissioned Report in doing so.

We also urge the Commission to re-examine the accuracy of the implicit assumption in the Advisory that current open and competitive markets are unable to handle large size trades. In the analysis provided in the CBOT-commissioned Report, the authors provide clear empirical evidence that CBOT members regularly accommodate orders of considerable size through our liquid open-outcry pits. Testing of the nearby Treasury bond data demonstrated that on a random date, "58% of the trading volume involved orders for 100 contracts or more, and 37% of the trading volume involved orders for 200 contracts or more."

Conclusion:

The CFTC in its Concept Release indicated that it was interested in encouraging debate on alternative execution procedures. The CBOT offers these additional comments in an effort to assure that the Commission continues such debate in the public arena. By utilizing the public comment process as part of any "flexible" CFTC review, all of those potentially affected by what may evolve into an ad hoc standard-setting process at the CFTC will be aware of, and can participate in, the analysis of specific proposals to alter the CEA's requirement for open and competitive trading, an historic underpinning of the law.

Sincerely,

Thomas R. Donovan

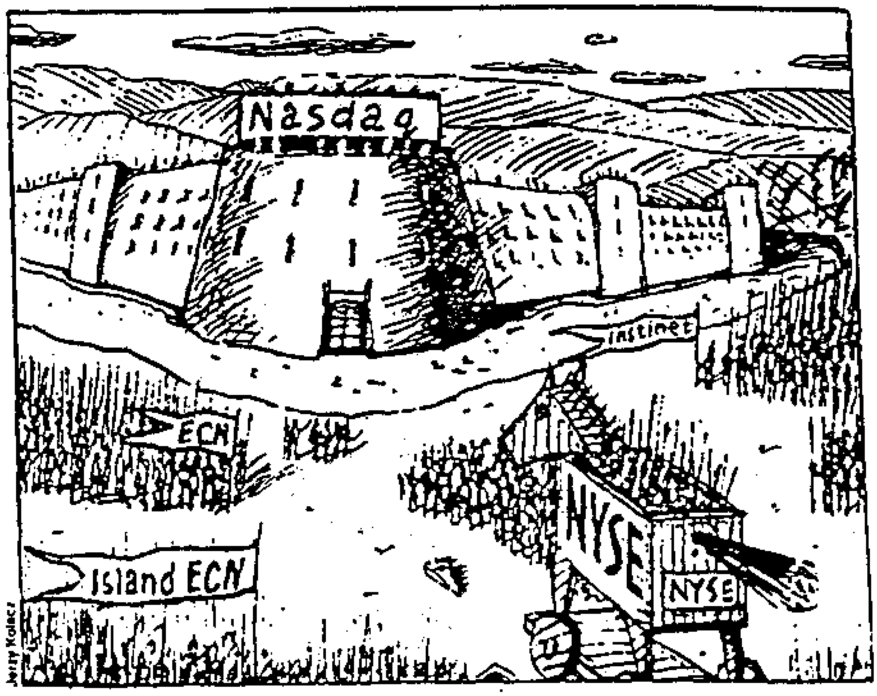
Thomas R. Donovan

cc: The Honorable Barbara Pederson Holum
The Honorable James E. Newsome
The Honorable Thomas J. Erickson
Mr. I. Michael Greenberger, Director, Division of Trading & Markets

Wall Street Journal
June 10, 1999

Structure Problems: Fragmented Nasdaq May Become Vulnerable to Competition

By Greg Ip
Staff Reporter of The Wall Street Journal



The price rise of theglobe.com's stock on its first day of trading last Nov. 13 was the most spectacular ever for an initial public offering. But the trading session also was one of the messiest ever on the Nasdaq Stock Market.

Theglobe.com was priced the night before at $9 a share. The next morning, there was a crush of demand. At the opening, some investors bought it for $96 to $97 a share from Mayer & Schweitzer Inc., a unit of Charles Schwab Corp. At the same time, underwriter Bear Stearns Cos. was selling shares for $90, and someone sold it on Instinet Corp.'s screen-based trading system for $87. The apparent result: Some buyers overpaid or some sellers sold too low.

The controversial opening illustrates the structural problems plaguing Nasdaq. Though it once boasted of being "the stock market for the next hundred years," Nasdaq's inability so far to resolve these issues could make it vulnerable to competition from upstart electronic exchanges and, perhaps soon, from the New York Stock Exchange, too.

By all accounts, the 1997 reforms that followed an investigation into dealers' alleged fixing of stock prices made Nasdaq a fairer market. But those reforms, coupled with advances in electronic trading, are fragmenting Nasdaq into many submarkets, making it harder to ensure that buyers and sellers are getting the best price. "It's an absolute Frankenstein," Douglas Atkin, chief executive officer of Instinet, said at a conference in March.

The National Association of Securities Dealers, Nasdaq's parent, thought it had a solution last year to this problem: a "central limit order book" into which investors and dealers from around the country could funnel orders. Big brokerage firms and institutional investors backed it as an essential step. But some firms saw it as proof that NASD management was bent on competing with its own members. Seeing a threat to their livelihoods, those members fought and killed the proposal.

NASD's chairman and chief executive officer, Frank Zarb, and its president, Richard Ketchum, have responded to that defeat with a series of reforms they hope will blunt investors' biggest complaints about Nasdaq while keeping members happy. "The next set of steps gets us a long way to addressing the problems that are frustrating people," Mr. Ketchum says confidently.

If they don't, the competition awaits, mainly in the form of about 10 quasi-stock exchanges called "electronic communications networks," the largest of which is operated by Instinet. The Big Board is talking to several of these ECNs about forming a new stock market to trade Nasdaq's busiest stocks under the New York Stock Exchange's name. Separately, some ECNs — which are now NASD members and trade 30% of Nasdaq's volume — may quit the NASD and become stock exchanges themselves. These potential rivals threaten the more than $300 million that the NASD earns annually on transactions and data fees, 42% of its total budget.

The irony is, Nasdaq's challenges today are a result of its phenomenal success. Born in 1971, it grew to challenge the Big Board and not only surpassed but eventually bought the American Stock Exchange. At first, Nasdaq was simply a network on which dealers posted bid and ask prices for small, thinly traded stocks. They risked their own capital to trade with investors and, in return, pocketed the bid-ask spread. That contrasted with the Big Board, whose members usually act as agents to match buyers and sellers and charge a commission for the service.

Nasdaq was also decentralized. Dealers executed orders either internally or by telephoning or e-mailing each other. That, too, contrasts with the centralized trading floor of the Big Board, where more than 80% of the volume in its stocks is sent, either by hand or electronically, to a designated spot on the floor. (The remainder trades on regional exchanges and among NASD members.)

Over time, many companies, such as Microsoft, elected to stay rather than jump to the Big Board. This changed the nature of Nasdaq. While investors needed to trade small, untried stocks through dealers because there weren't a lot of natural buyers and sellers around, there was no shortage of buyers and sellers for Microsoft. And institutional investors increasingly bypassed dealers and their spreads to trade such stocks directly with each other through Instinet, now a unit of Reuters Group PLC.

This two-tiered market — one for institutions and dealers, and one for everyone else — collapsed when the government began its investigation in 1994 into alleged collusion by Nasdaq dealers to keep spreads wide. Widespread reforms following that investigation have shrunken dealers' spreads and profits. Some firm members have put full-time compliance officers on their Nasdaq desks to deal with the blizzard of rule changes. The volume of orders through Nasdaq's e-mail system, called SelectNet, has repeatedly slowed and even crashed the system.

All of which bothers people like Arthur Pacheco, who has traded over-the-counter stocks since 1965, most recently for Bear Stearns. He says Nasdaq is abandoning its roots trading small stocks among dealers and disagrees with management's priorities. "The NASD thinks nothing of going out and paying millions of dollars for a billboard in Times Square, but they can't seem to get the technology right. Philosophically, what drives them increasingly is competing with [the Big Board] and, recently, their own constituencies."

So last year, he helped form a new ECN called Strike Technologies, in which numerous dealers have invested. Strike is one of several ECNs that is interested in joining a super-ECN run by the Big Board to trade Nasdaq stocks.

While ECNs are technically brokerage firms, the NASD has come to see them as competitors because they act more like stock exchanges, displaying a "book" of investors' buy and sell orders but not committing capital to trade them. ECNs show their best-priced orders on Nasdaq, but the rest are accessible only to subscribers. The NASD cited the plans of some ECNs, such as Eclipse Trading Inc., to trade at night as a competitive reason to do the same.

While the growth of ECNs and other trading systems has spurred innovation, institutional investors would generally prefer to look in just one place for the buyer or seller of a block of stock. Says Andrew Brooks, head of trading for mutual-fund giant T. Rowe Price Associates, "What we have today is incredible fragmentation, all in the name of competition."

Since April, ECNs have been allowed to go the final step to compete with both Nasdaq and the Big Board by applying to become stock exchanges. In May, Instinet, with 20% of Nasdaq's volume, bought a stake in Britain's Tradepoint Financial Networks PLC, a tiny for-profit stock exchange. Tradepoint is cleared to trade British stocks in the U.S., but Mr. Atkin says it could become a venue to trade U.S. stocks. Island ECN, with 6% of Nasdaq's volume, has also applied to become an exchange. Had the NASD built a central limit order book, it "would have put both Instinet and Island out of business," says Joshua Levine, an Island founder.

The NASD has long wanted a central order book. In the one Mr. Zarb proposed last year, no buyer would pay more than the lowest seller was asking. The first order to arrive would be the first executed. All opening orders could be executed at one price, avoiding the chaos of theglobe.com's opening.

Most important for big investors like Mr. Brooks, it would, if successful, give him just one place to look for other investors with whom to trade, instead of a dozen. And it was exactly that threat to their own existence that prompted the ECNs and some dealers to oppose a central order book so vociferously that the NASD, after consulting with the Securities and Exchange Commission, shelved the plan.

In a letter to the SEC, David Pottruck, co-chief executive officer of Schwab, whose Mayer & Schweitzer unit is Nasdaq's second-biggest dealer, accused the NASD of "total disregard for the competitive burdens of the proposal." Dealers and ECNs "would find themselves competing directly with their regulator on their regulator's terms." He said brokers would feel they ought to send orders to Nasdaq's book instead of dealers or ECNs simply because it had their regulator's seal of approval.

Now the NASD is proceeding with several less-ambitious steps: allowing dealers to separately display their own and their customers' orders in Nasdaq, speeding up SelectNet by enabling it to automatically execute orders, and compelling ECNs to display previously hidden orders. Mr. Ketchum and Mr. Zarb hope these steps will make Nasdaq feel more centralized.

But in April, with the SEC's support, they also quietly resurrected the central order-book proposal. While the same opponents are lining up against it, the result may be different since the news in February that the New York Stock Exchange was considering, in essence, building Nasdaq's central order book. The Big Board is to decide whether to proceed this summer. The news prompted Mr. Zarb to announce that the Big Board should first remove some of its own anticompetitive rules. But it has also added urgency to his efforts to garner support for the order book, especially among smaller dealers.

Says Mr. Ketchum, "It would not be an even playing field, and quite ironic, if the first market to have a limit order book in Nasdaq stocks would be the New York Stock Exchange."

—Terzah Ewing contributed to this article.