



U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5430
Facsimile: (202) 418-5536

98-7
NCG
COMMODITY FUTURES
TRADING COMMISSION
RECEIVED
OFFICE OF THE
SECRETARY

JUN 11 3 42 PM '98

CFTC

DIVISION OF
TRADING & MARKETS

June 11, 1998

COMMODITY FUTURES
TRADING COMMISSION
RECEIVED FOR
PUBLIC RECORD
JUN 12 10 57 AM '98

COMMENT

Michael R. Koblenz, Esq.
Mound, Cotton & Wollan
One Battery Park Plaza
New York, New York 10004-1486

Re: Application of Cantor Financial Futures Exchange for
Designation as a Contract Market in US Treasury Bond,
Ten-Year Note, Five-Year Note and Two-Year Note
Futures Contracts

Dear Mr. Koblenz:

The Division of Trading and Markets ("Division") has been reviewing the application of the Cantor Financial Futures Exchange, Inc. ("CFFE" or "Exchange") for designation as a contract market as submitted by the CFFE in letters dated January 6, 1998, through May 21, 1998. Based upon this ongoing review, the Division has a number of questions with respect to the Exchange's application. You will note that most of these questions seek clarification of information that CFFE provided to the Division in its letter of May 21, 1998. Where appropriate, this letter cross-references CFFE's May 21, 1998, letter by referring to appropriate question and answer numbers.

Please fully address the following items:

1. The introduction to the CFFE's By-Laws subjects holders of trading privileges to the rules of New York Cotton Exchange ("NYCE") where they are referenced in CFFE's rules, but does not specifically provide that such persons are subject to the rules of CFFE. Associate Members, under proposed By-Law Section 35-C(2), would be required to agree in writing to abide by the By-Laws and Rules of CFFE, but other holders of CFFE trading privileges would not be so required.
 - a. How would holders of CFFE trading privileges be made subject to CFFE's rules?

- b. Please provide the Division with a copy of the agreement referred to in CFFE By-Law Section 35-C(2).
 - c. It appears that no CFFE rule provides, or refers to, a NYCE rule which provides that CFFE and NYCE jurisdiction over a holder of CFFE trading privileges continues after the termination of such person's trading privileges. CFFE should adopt provisions which establish these conditions.
2. CFFE proposed Rule 712(b) does not comply with two provisions of Commission Regulation 1.59(b)(i). Specifically, Rule 712(b) does not include a prohibition on employees trading "in any related commodity interest, [or] in any commodity interest traded on or cleared by contract markets or clearing organizations other than the employing self-regulatory organization. . . ."
3. In its answer to question 69, CFFE indicates that the Clearing Time period for each of the proposed contracts would initially be zero seconds. In light of the fact that a Clearing Time period of zero seconds in length means that CFFE would operate with no Clearing Time function, the Division recommends that, for the present time, CFFE withdraw all of its pending rule provisions that pertain to Clearing Time.
4. In its answer to question 1.b, CFFE states that it will not itself have arbitration or oversight committees, but that the NYCE committees will instead carry out the functions of those committees. The Division recommends that CFFE submit CFFE rules providing for NYCE committees to serve those purposes. This could be accomplished by referencing relevant NYCE rules as CFFE currently does with respect to disciplinary proceedings in its proposed Rule 500.
5. CFFE's May 21, 1998, letter includes a revised version of the CFFE's By-Laws and Rules. Please provide the Division with an additional copy of these provisions with brackets indicating words that have been deleted and underlines indicating words that have been added since the previous versions of these By-Laws and Rules.
6. Is Cantor Fitzgerald Securities registered in any capacity with the Securities and Exchange Commission and, if so, as what?
7. In its question 26, the Division requested "any report or findings" resulting from any investigation of whether traders for any Cantor affiliate gained an advantage by obtaining access to terminal screens used by Cantor Fitzgerald Securities Terminal Operators ("TOs") for interdealer brokerage. In response, CFFE provided the Division with an August 7, 1997, letter from Richard C. Breeden and Brandon Becker to James Michaels describing "an

independent review" that Breeden and Becker performed of the "trading structure utilized by Cantor Fitzgerald Securities." Please provide the Division with a copy of the independent review underlying this letter.

8. In its answer to question 27, CFFE indicates that a Cantor Fitzgerald entity other than Cantor Fitzgerald & Co, its futures commission merchant ("FCM") subsidiary, would manage the error account maintained to correct erroneous transactions by CFFE TOs.
 - a. Would this entity be an existing Cantor Fitzgerald subsidiary? If so, what subsidiary?
 - b. Would this Cantor Fitzgerald entity have any function other than correcting erroneous TO transactions? If so, what other functions would it perform?
 - c. Would Cantor Fitzgerald & Co. have an error account to handle errors made by its account executives?
9. The Commission has received several comments on the CFFE's proposal which state that Cantor Fitzgerald and some of its subsidiaries would play an integral role in the operations of the CFFE while also being able to trade on the Exchange. Some of these commenters have raised particular questions about the safeguards that would be in place to ensure that Cantor Fitzgerald could not use its position to gain unfair advantages over other market participants. While the Division recognizes that the CFFE's submission includes a number of features which prescribe the conduct of Cantor Fitzgerald and its subsidiaries at the Exchange, the CFFE may wish to provide the Commission with a comprehensive description of measures the Exchange would have in place in this regard.
10. Would Class B memberships in CFFE be given only to holders of full NYCE memberships, or would Class B memberships be separately available to qualified applicants without the purchase of a NYCE seat? If a Class B membership may be purchased separately, please state the procedures, qualifications, and payments relevant to the application process, and note any differences which would exist between that process and the process for obtaining a full NYCE membership.
11. Please confirm that an FCM, introducing broker ("IB"), or commodity trading advisor ("CTA"), who under CFFE By-Law 36 would be eligible to obtain trading privileges on CFFE, would be required to obtain either a Class B or Associate Membership in CFFE in order to execute trades on CFFE.
12. Under CFFE Rule 4, an Authorized Trader of a Clearing Member of CFFE would not be required to be a Commission registrant. The Act makes no distinction between contract market clearing members and other FCMs and

IBs with respect to registration of their employees, who accept and solicit customer orders, as Associated Persons. If Authorized Traders of Clearing Members are intended to act in any way other than in a strictly clerical capacity, please amend CFFE Rule 4 to require that Authorized Traders of CFFE Clearing Members be registered.

13. CFFE has agreed that an Associate Member would not be permitted to trade for customer accounts on CFFE unless that member is a registrant. Please amend CFFE By-Law 35-A(a) to codify this condition.
14. To what types of entities does CFFE anticipate granting Associate Memberships?
 - a. Would Cantor Fitzgerald Securities' current cash market customers be eligible for Associate Memberships?
 - b. Would TOs, by virtue of their floor broker registration status, be able to receive orders directly from customers of CFFE members?
 - c. Would TOs be able to act as Associated Persons of Cantor Fitzgerald & Co, Cantor's FCM subsidiary, through their employment by Cantor Fitzgerald Securities?
15. Question 47. e. asked whether TOs would be able to "solicit orders or recommend strategies to Authorized Traders." In response, CFFE stated "yes, but it is unlikely that they would do so in practice." Please clarify your answer by addressing both whether TOs would be able to solicit orders and whether TOs would be able to recommend strategies. Also, please explain why it would be unlikely that TOs would engage in either or both of these activities.
16. In its answer to question 47, CFFE indicates that, rather than inputting orders in a purely clerical manner, TOs would be able to engage in other activities such as providing Authorized Traders with market color, initiating contacts with Authorized Traders to advise them of buying and selling interest, and, possibly, recommending trading strategies to Authorized Traders. Please explain whether any of these activities and other activities that TOs could engage in are consistent with Regulation 1.59 and its prohibition on self-regulatory organization employees disclosing material non-public information to any other person "where such employee has or should have a reasonable expectation that the information disclosed may assist another person in trading any commodity interest. . . ."
17. Please describe what information a TO would be able to disclose to an Authorized Trader with respect to the priority of his or her orders (e.g., how many orders, or how many contracts are being bid for or offered ahead of him or her).

18. CFFE promotional material indicated that cash and futures transactions could be conducted in one phone call. How, and by whom, will this be done?
19.
 - a. In its answer to question 47.i., CFFE states that TOs would be required to sign a written agreement regarding policies and procedures to be observed in connection with all CFFE trading. Please provide the Division with a copy of this agreement.
 - b. In its answer to question 47.i., CFFE also states that TOs would be required to attend seminars administered by Cantor Fitzgerald. Would such seminars be similar in nature to the broker training program of NYCE? Would TOs be required to pass an examination such as those administered by other contract markets and the NFA to ascertain an applicant's qualifications prior to approval of his or her registration?
20. In its answer to question 53, CFFE states that TOs shouting the terms of orders "serves to alert TOs to sudden changes in market prices or to particular trades." If a TO was entering orders for a given contract, would not that TO be aware of any such conditions based on the information on his or her terminal screen? If a TO was not currently entering an order for a customer in a given contract why would they need to have their attention drawn to such activity?
21.
 - a. In its answer to question 59, CFFE indicates that TOs would be solely employed by Cantor Fitzgerald Securities, rather than jointly employed by Cantor Fitzgerald Securities and CFFE as originally described by CFFE. With the modification it appears that TOs would not be subject to the disclosure and trading prohibition of CFFE Rule 712, CFFE's Regulation 1.59-implementing provision. Please revise either Rule 712 or the definitional section of CFFE's By-laws to ensure that TO's are fully subject to CFFE Rule 712. In addition, please ensure that no other provision of CFFE's By-laws and Rules would be similarly impacted by the revised employment status of TOs.
 - b. In its answer to question 59, CFFE also indicates that a TO's compensation would include "a payment/discretionary bonus in respect of their services for CFFE, LLC." Would any portion of their bonus be based upon the volume of trades they execute on the CFFE? Please explain. Would it be based on the volume of CFFE trades executed by Cantor Fitzgerald & Co.
22. Please identify CFFE personnel that would have the ability and/or authority to activate and deactivate view-only CFFE terminals. Would these

operations be done from a central location, or would this be done at the remote terminal's location?

23. Proposed CFFE Rule 308(c) states that "to the extent that CFFE does not acknowledge any responsibility of the [TO] for any alleged error . . . , the Clearing Member affected by such error will be notified thereof [via facsimile] by the [Commodities Clearing Corporation ("CCC")], and asked to respond to such notifications within 30 minutes from receipt thereof." Please describe the type of notice that would be sent to clearing members. Would the notice exclusively pertain to transactions that were the subject of an error dispute and would it make that fact plain to the reader, or would it be the regular transaction information being sent to the CCC for clearing purposes? How would a clearing member determine whether a given trade conformed with the terms of the order it purported to fill? Please explain why CFFE believes that this reasonably could be done within 30 minutes after receipt of trade data from CCC?
24.
 - a. Please describe in detail any system failures experienced by Cantor Fitzgerald Securities since cash trading on the Cantor System began. Please provide details regarding the causes of, and recoveries from these failures, as well as information on the duration and frequency of these failures.
 - b. The Customer Information and Risk Disclosure Statement states that in the event of a system failure it may not be possible to enter new orders or cancel orders that were previously entered. Please amend this statement to inform customers that during such periods of system failure, no orders would be matched.
25. The Customer Risk Disclosure Statement states that "[TOs] accept only orders to buy or sell contracts at a certain price . . ." Please amend this statement to reflect the fact that such orders would not include stop orders or limit orders with contingencies away from the market price at the time of entry. Also, please add language that informs the customer that an Authorized Trader could accept other forms of orders, but that the Authorized Traders, not CFFE, would be responsible for the execution of such orders by their terms.
26. The CFFE's has indicated that initially there would be a ten-contract minimum trading requirement for CFFE orders?
 - a. Would CFFE orders for less than the ten-contract minimum trading requirement be rejected by the trading system upon input, or would the CFFE rely on TOs not to accept such orders?

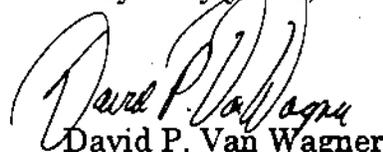
- b. When trades are "worked-up" during execution time, would there be any minimum level of contracts by which orders must incrementally increase? Is there any traditional minimum work-up increment in the cash market for Treasury securities and, if so, what is it?
 - c. Is there a reason for the proposed contract size of \$100,000 given that the minimum transaction size for regular trading on CFFE would be 10 contracts (\$1 million)?
27. Proposed CFFE Rule 314-B would establish procedures for determining a crossing price that would apply to market crossing trades under CFFE Rule 303-A. Generally, Rule 314-B provides that the crossing price would be derived from the price of a single trade randomly selected from a three-minute interval of trades immediately following a market crossing.
- a. Would CFFE have the authority to set an alternative price if it determined that the randomly-selected price was not representative of trade prices during this three-minute interval? Please explain.
 - b. Rule 314-B also states that if no trade with respect to a particular contract was executed during this three-minute interval, no market crossing price would be established. Please confirm that, accordingly, there would be no market crossing trades executed in this situation. If so, what would be the status of eligible market cross orders that were not executed in such a situation? Would they remain resting in the trading system eligible for matching with the same time priority until the next market crossing session, or would they be deleted from the system?
 - c. Would NYCE conduct any special trade surveillance on transactions executed during the three minutes following a market crossing session by customers who participated in the market crossing? Please explain.
28. Would there be any circumstances in which outstanding "non-market crossing" bids and offers pending in the system at the time of a market crossing session would be eligible for execution pursuant to market crossing procedures? For example, if the price randomly selected as the market crossing price was the same as either the best bid or offer resting in the system at the time, would orders at such bid or offer be included in the market crossing session?
29. In its answer to question 45, CFFE describes how CFFE orders would be processed, starting with the receipt of orders by TOs. Please expand this description to include the steps performed by Authorized Traders upon receipt of orders and receipt of fills with respect to preparation and retention of records such as order tickets.

30. CFFE Rule 316(b) requires that Authorized Traders prepare order tickets for customer orders which include timestamps indicating the time of receipt of the order and the time the Authorized Trader transmits the order to a TO for execution. Are Authorized Traders required to place additional timestamps on an order when resubmitted to a TO (e.g., if it were posted, and then trumped by a better bid or offer)? If so, please amend Rule 316(b) to state that a timestamp must be placed on an order ticket each time the order is transmitted to a TO.
 - a. Would Authorized Traders be required to stamp order tickets upon reporting a fill to a customer?
31. CFFE has represented that trade data would be recorded and timed to the nearest second. Would the CFFE trading system be capable of timing events in increments smaller than one second?
32. Would the CFFE trading system have the capacity to include built-in credit limits whereby the system would, based upon an account identifier or other information, impose limits on the size of positions which could be taken, or the size of orders which could be executed for a particular account?
33. In the "Schedule VII" attachment to CFFE's May 21, 1998, letter, which addresses the integration of CFFE into NYCE's compliance program, CFFE describes the "Data Entry Transaction Log", the "Transaction Log", and the "Changes to Executed Transaction Log".
 - a. Would NYCE compliance have a log available that lists changes to data entry transactions, such as changes to the account identification of unexecuted bids and offers?
 - b. The descriptions of the various logs list the categories of data they would contain. Would the identities of the Screen Based Trader and Authorized Trader involved in each trade be detailed in these logs?
34. In its answer to question 58, CFFE indicates that NYCE personnel would conduct reviews of TO activity both "randomly and at scheduled intervals."
 - a. Please identify a minimum frequency with which NYCE personnel would visit CFFE's trading room to monitor TO activity.
 - b. Please also state the frequency with which NYCE personnel would conduct "spot checks" of TO phone-line tapes.
35.
 - a. Please confirm that Commission staff would have access to the CFFE trading room to observe CFFE trading.
 - b. Please confirm that CFFE would provide the Commission's New York Regional Office with a terminal upon which CFFE trading could be monitored, and that both customer and TO screens would be viewable on this terminal.

- c. Please confirm that the CFFE would provide the Commission with transaction records in a similar or functionally equivalent manner to the way in which NYCE transaction records are currently provided to the Commission.
36. In its answer to question 99, CFFE represented that it will retain tapes of TOs' telephone lines for 20 business days. Given that customer complaints or member referrals of volatile trading activity may be received by compliance staff at any time after a given trade date, the Division believes that 20 business days is an insufficient length of time to retain tapes to ensure availability of relevant material for investigations. The Division believes 180 days would be a more appropriate length of time for retention of these tapes.
37. In its answer to question 39, CFFE maintains that its proposal does not raise any issues under the Commission's Part 156 broker association rules because only entities who already are covered by the Part 155 regulations, such as FCMs, CTAs, and IBs would be able to act for customers. The registration of broker associations alerts compliance personnel to the fact that certain traders may have access to one another's customer orders, and should be considered affiliated for the purpose of trade surveillance. Please explain how CFFE would ensure that holders of trading privileges that were affiliated with one another in such a way could not violate Part 155 standards, such as trading ahead of orders and improper cross-trading, without detection.

Please contact me a (202) 418-5481 or Adam Wernow at (202) 418-5042 if you have any questions concerning issues raised by this letter.

Very truly yours,


David P. Van Wagner
Special Counsel