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COMMENT

Amex.

American Stock Exchange

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Executive Vice President
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April 3, 1998

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

Re: Cantor Fitzgerald Futures Exchange, Inc, ("CFFE") Application for Designation as a Contract Market in U.S. Treasury Bond, Ten-Year Note, Five-Year Note, and Two-Year Note Futures Contracts (the "Application")

Ms. Webb:

The American Stock Exchange ("Amex")¹ respectfully submits the following comments relative to the Application for contract market designations for a new exchange organized by various affiliates of Cantor Fitzgerald L.P. (the "Cantor Group") and the New York Cotton Exchange (the "Cotton Exchange" or "NYCE"). The Amex, through its Amex Commodities Corporation subsidiary, previously was designated as a contract market for U.S. Treasury Securities² and many of the concerns stated in this correspondence contributed to our recent withdrawal from a similar joint venture to develop a new Treasury futures market. Our comments are based upon the description of the Application published by the Commission in the Federal Register³ (the "Release") as well as documents submitted by the CFFE's organizers in support of the Application and correspondence between Commission staff and the CFFE's organizers, as obtained by Amex through a Freedom of Information Act request (the "CFFE Filings").⁴

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¹ The Amex is a national securities exchange which provides a market for stocks, corporate bonds, options and derivative products. It also operates a market for odd-lot trading of U.S. Treasury securities.

² Order of Designation dated September 26, 1989 in respect of Ten-Year U.S. Treasury Note futures contracts and Order of Designation dated November 21, 1989, in respect of Two-Year U.S. Treasury Note futures contracts.

³ 63 FR 5505 (February 3, 1998).

⁴ The FOIA request No. 98-0167 was made to the Commission by the Amex Commodities Corporation.

1. Summary

As explained more fully below, the Application and CFFE Filings describe a proposed hybrid manual/electronic futures market for U.S. Treasury securities. The proposed market will be controlled by the Cantor Group, which will (i) appoint a majority of the Board; (ii) handle all order flow by employing the computer terminal operators receiving orders; (iii) own and operate the computerized order matching system and (iv) distribute all market data. This concentration of market functions within one group raises fundamental public interest questions that are compounded by the fact that the Cantor Group appears to be beyond the self-regulatory reach of the CFFE or the New York Cotton Exchange, as well as the regulatory reach of the Commission itself. We submit that combining the role of exclusive access provider to the market with the apparent inadequacy of regulatory oversight, raises significant public policy concerns under the Commodity Exchange Act. Consequently, we urge that contract market designation not be granted unless and until the CFFE provides for (i) limitations on the Cantor Group's ability to act in an anti-competitive manner towards other participants in the CFFE; (ii) adequate CFFE and Commission oversight of all persons controlling exchange access, order execution and market data flow; and (iii) a regulatory plan that is sufficiently detailed to assure that the Cantor Group and its employees do not abuse their unique place in the market as exclusive access providers.

2. Overview

The instant Application seeks to establish the CFFE as a futures exchange for U.S. Treasury securities. The Release states:

CFFE has been formed pursuant to an agreement between the New York Cotton Exchange ("NYCE") and CFFE, LLC ("Cantor") which is wholly owned by Cantor Fitzgerald, LP. Under the agreement, CFFE trading would be conducted on the same trading system that another Cantor Fitzgerald LP subsidiary, Cantor Fitzgerald Securities, LLC currently operates as an interdealer-broker in US Treasury securities. CFFE's regulatory responsibilities would be handled by NYCE.

Based upon the Release and CFFE Filings, all orders for CFFE futures would be telephoned to "terminal operators" who would be dual employees of Cantor Fitzgerald Securities (the interdealer broker of Treasury securities) and CFFE.⁵ Cantor would have sole authority to "designate" terminal operators. The CFFE's trading system, as well as its data flow, would be owned by Cantor and its affiliates.⁶ Cantor will also appoint a majority of the CFFE board of directors.⁷ The New York Cotton Exchange, accordingly, would not possess the traditional controls exercised by self-regulatory exchanges over the mechanisms of their market: ownership of the trading systems and data flow, and the undivided loyalty of its employees operating the system.

⁵ Proposed CFFE Rule 31. See also items 28 through 30 in the "Draft Responses to CFTC Questions Concerning CFFE and NYBOC" obtained by AMEX pursuant to FOIA request.

⁶ Proposed CFFE Rule 8.

⁷ Proposed CFFE By-Law Section 1.

Nothing in the Release or the CFFE Filings suggests that any Cantor entity, partner, or employee would be a member of CFFE or the New York Cotton Exchange. Consequently, it appears that these persons are all outside of the regulatory jurisdiction of CFFE and NYCE. In addition, there is no suggestion that the Cantor entities involved in this project are registered, or will be required to be registered, in the capacity of a Futures Commission Merchant, Introducing Broker, Commodity Trading Advisor, Contract Market or Floor Broker. Thus, those who own and control CFFE trading system and the persons operating that system are seemingly beyond the Commission's jurisdiction which necessarily undermines the Commission's ability to police the order flow, order matching, and trade reporting process. This regulatory arrangement is analogous, for example, to a currently designated contract market being exempt from direct Commission oversight except for its self-regulatory departments.

3. Cantor Fitzgerald Securities is the Exclusive Access Provider to CFFE

According to the Release and the CFFE Filings, the Cantor Fitzgerald Securities trading system that will be used by CFFE is a hybrid electronic/manual system. Members of CFFE will receive information regarding the best bid and offer by means of a data feed from Cantor. Members wishing to place orders for CFFE futures will be required to do so by telephone call to a terminal operator employed by Cantor Fitzgerald Securities. The terminal operator is responsible for entering the order into a matching engine that pairs-off orders according to an algorithm. No orders to open or close a position in CFFE futures may enter the trading system except through an employee of Cantor Fitzgerald Securities.

Cantor Fitzgerald Securities is a leading and perhaps the dominant interdealer broker for U.S. Treasury securities in the cash market.⁸ If the Commission were to approve the Application, the Cantor Group would have obtained a government approved monopoly with respect to information and order access to the CFFE. Since the various Cantor Group entities interested in this project are not subject to the Cotton Exchange's or the Commission's jurisdiction, there would be no regulator to check possible abuses by the Cantor Group of its dominant position in the market. Furthermore, the CFFE Board, under the control of Cantor appointees, cannot be reasonably relied upon to restrain Cantor. This risk that the CFFE will favor Cantor Fitzgerald Securities over members and customers is, for example, reflected in the arbitration rules.⁹

The distribution of market data is an area where, we submit, the potential for abuse needs to be checked. The CFFE Filings state Cantor will provide members with a data feed. This data feed will supply members with information regarding the best bid and offer and other data. The CFFE Filings are silent, however, as to whether there will be any charge for this data feed, how this fee will be determined, whether there will be different charges for different persons or classes of persons (and, if so, the rationale for such distinctions), and whether there will be different levels of service

⁸ "Getting Between the Wall and the Wallpaper," *FORBES*, October 20, 1997, pages 67-84.

⁹ Proposed Rule 308(c) "Errors of Terminal Operators" provides that a member must respond in writing within 30 minutes of receipt of a fax declining Cantor's responsibility for an error or else waive its claim. We note the obvious "one sidedness" of requiring a response to a fax within 30 minutes of transmission when many of these communications are never seen by the intended recipient within this time.

provided to different participants in the market.¹⁰ Consequently, it is unclear how Cantor, having a Commission approved exclusive right to perform critical market functions, but unfettered by Commission oversight, will allocate and price its various services. For example, persons with direct lines will have a competitive advantage relative to persons that do not. Cantor appears to be able to determine who receives a direct line to the terminal operators, and to impose different charges for the same level of service without regulatory oversight. The proposed By-Laws and Rules also provide that CFFE members are subject to various fees and dues as determined by the Cantor dominated CFFE Board. There are no standards in the By-Laws and Rules, however, limiting the discretion of the Board as to dues and fees. The Board, to which Cantor will appoint a majority of directors,¹¹ accordingly, could establish varying fees and dues for different individual market participants or classes of participant with consequent anti-competitive effects.

Section 15 of the Commodity Exchange Act requires the Commission to take the least anticompetitive means of achieving the purposes of the Act in reviewing the bylaws, rules and regulations of a contract market.¹² We submit that Section 15 requires (i) the Commission to obtain from CFFE supplemental By-Laws and Rules that address the potential for anti-competitive practices with respect to market access, service levels, and charges and (ii) that the Cantor Fitzgerald Securities and any Cantor affiliate or personnel acting as the exclusive access provider or data distributor for the CFFE, a public futures market, should be subject to the Commission's and the Cotton Exchange's jurisdiction.

¹⁰ Proposed Rule 10 "CFFE Terminal" provides:

"CFFE Terminal" shall mean any manner of dissemination or display (including stand-alone, digital feed or other dissemination media provided by Cantor) which displays or disseminates certain CFFE Data for use by Authorized Traders, provided that the type of CFFE terminal may vary among users.

In response to a question from the Commission staff regarding proposed Rule 10, NYCE responded:

Only the CFFE Terminal itself (i.e., the hardware), not the function performed by any such terminal, may vary from one user to another. Such variations are necessary because of the specific data distribution technology being requested by certain users. (Item 3 in the "Draft Response to CFTC Questions Concerning CFFE and NYBOC.")

We submit that this answer is ambiguous and admits the possibility of different users receiving different levels of service from Cantor.

¹¹ Proposed By-Laws Section 1.

¹² Section 15 of the Commodity Exchange Act reads:

The Commission shall take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objective of this Act, as well as the policies and purposes of this Act, in issuing any order or adopting any Commission rule or regulation (including any exemption under Section 4(c) or 4c(b)), or in requiring or approving any bylaw, rule or regulation of a contract market or registered futures association established pursuant to section 17 of this Act.

4. Terminal Operators

The proposed CFFE differs from previously approved electronic trading systems (e.g., Globex) in that persons initiating orders do not enter their orders directly into the trading system for matching and execution. Instead, persons wishing to place orders for CFFE futures must telephone the orders to employees of Cantor Fitzgerald Securities (a leading broker in the cash market for government securities) who then input the orders into the Cantor system. The CFFE Filings stated that the terminal operators will perform solely clerical tasks of accepting and entering into the Cantor system the telephone futures orders of CFFE members.¹³ Yet, the CFFE Filings also state that the very same terminal operators will be registered with the NASD as "Government Securities Representatives."¹⁴ This suggests that the terminal operators are more than clerks in respect to the cash market, since the NASD's rules provide that government securities representative registration only is required for professionals engaged in sales, trading, and other "high level" activities. The NASD's rules specifically state that government securities representative registration is not necessary for persons performing "exclusively clerical or ministerial" functions.¹⁵

The potential difference between the cash and futures market activities of the terminal operators raises questions as to how the Cotton Exchange (or whomever is supposed to oversee the terminal operators) proposes to surveil the day to day activities of these individuals to ensure that they function exclusively in a clerical capacity in the futures market. We believe, moreover, that there is an issue as to whether it is even possible for a single person to act as a broker/trader in the cash market while simultaneously acting as a mere clerk in the related futures. For example, how would

¹³ See item 10 to the "Draft Responses to CFTC Questions Concerning CFFE and NYBOC."

¹⁴ See item 10 in "Draft Responses to CFTC Questions Concerning CFFE and NYBOC."

¹⁵ NASD Rule 1112 "Registration of Representatives" and 1113 "Persons Exempt from Registration" provide:

1112. Registration of Representatives

All persons associated with a member who are to function as government securities representatives who have not previously been registered shall be registered as such with the Association.

(a) Definition of Representative

Persons associated with a member, including assistant officers other than principals, who are engaged in the government securities business for the member including:

- (1) underwriting, trading or sales of government securities;
- (2) financial advisory or consultant services for issuers in connection with the issuance of government securities;
- (3) research or investment advice, other than general economic information or advice, with respect to government securities in connection with the activities described in subparagraphs (1) or (2) above;
- (4) Activities other than those specifically mentioned that involve communication, directly or indirectly, with public investors in government securities in connection with the activities described in subparagraphs (1) and (2) above;

are designated as representatives.

1113. Persons Exempt from Registration

Persons associated with a member whose functions are exclusively clerical or ministerial are not required to register with the Association.

a terminal operator handle a customer that expressed an interest in doing a simultaneous transaction in both the cash and the futures contracts?

Since the terminal operators, who will not be Commission regulated themselves, are the exclusive gateway to the proposed CFFE, we believe that certain questions, at a minimum, should be covered with respect to the activities of terminal operators in both the cash market for Treasury securities and the proposed futures market.¹⁶ The responses to these questions might indicate that terminal operators should be registered as associated persons of an FCM or IB rather than exempt from registration as proposed. Indeed, a site inspection of the terminal operator facility and observation of the manner of operation of the persons that will function as terminal operators might indicate that the terminal operator facility is a traditional trading floor and that floor broker registration would be more appropriate. This possibility is acknowledged in the materials supporting the application

¹⁶ We believe that the Commission's staff should obtain answers to the following questions regarding the cash and futures market activities of the proposed terminal operators:

- Will terminal operators be compensated on a commission basis?
- Will terminal operators be allowed to provide "market color"? For example, will they be able to express an opinion regarding the direction of the market or the strength of a trend?
- Will terminal operators provide information regarding buying and selling interest that is away from the best posted bid and offer? Will terminal operators be able to identify buyers and sellers or persons that have expressed buying and selling interest?
- Will terminal operators be able to discuss customer orders among themselves? Will they be close enough to do so?
- Will terminal operators be able to initiate contact with customers to advise them of buying and selling interest? Will terminal operators be permitted to initiate contact with customers under any circumstances? For example, could they initiate a call to discuss the cash market and then move on to related futures transactions?
- Will terminal operators be able to solicit orders or recommend strategies?
- How will terminal operators handle combination orders for both the Treasury futures and the underlying Treasury securities?
- Will terminal operators be able to initiate orders on a discretionary basis? Will terminal operators be allowed to exercise time and price discretion over orders, e.g., accept a "not held" order?
- What use may terminal operators make of information they receive as a result of handling orders for the futures and/or cash Treasury securities? In this regard, we note that Proposed rule 712 "Disclosure and Trading by Employees of CFFE" limits employee disclosure to information that "could assist another person in trading any *Contract*." (Italics supplied.) The term "Contract" is defined in the proposed rules to mean only contracts listed on the CFFE. (Proposed Rule 15.) Query: would the proposed rules permit employee disclosure of information that could assist another person in trading a futures contract for Treasury securities listed on another exchange? What about disclosing information regarding a large order for the cash market Treasury securities to a CFFE participant?

where it is stated that every 10 terminal operators would be supervised by a person registered as a floor broker.¹⁷

Despite the critical role played by terminal operators in the order handling process and the fact that they are registered by the NASD as securities industry professionals, the proposed By-Laws and Rules of CFFE do not define the activities of terminal operators with any specificity.¹⁸ While supporting materials submitted in connection with Application state that terminal operators only will perform clerical functions and include various descriptions of what terminal operators may or may not do,¹⁹ these discussions are not incorporated into the By-Laws and rules. It is unclear, accordingly, whether these descriptive materials would be enforceable even if the terminal operators and the Cantor affiliate that employs them were subject to the Cotton Exchange's self-regulatory jurisdiction.

5. Self-Regulatory Plan

The CFFE Filings do not include a written self-regulatory plan that sets forth procedures to ensure that terminal operators and their employer do not abuse their central position as the exclusive access provider to the market and are acting in conformity with the Application. We believe that there is a particular need for such a plan with respect to the proposed CFFE due to the concentration of market functions within the Cantor Group and the apparent lack of self-regulatory jurisdiction over the Cantor Group and its employees. Perhaps a self-regulatory plan will illuminate the manner in which the Cotton Exchange proposes to regulate the terminal operators, the Cantor system and Cantor Fitzgerald Securities when none of these persons appear to be subject to the self-regulatory jurisdiction of the NYCE. For example, may the Cotton Exchange as the SRO for the CFFE fine, suspend, bar or take other appropriate disciplinary action against a member of the Cantor Group or one of its employees for misconduct arising from their activities in the CFFE?²⁰ If the Cotton Exchange or the Commission were to suspend or expel one of the Cantor Group for misconduct, what would happen to the CFFE's trading system and customer positions in CFFE futures? Would the market cease to operate? Are the sanctions of suspension or bar not realistically available to the regulators of the CFFE with respect to a member of the Cantor Group as the imposition of such sanctions would close the market? A self-regulatory plan could clarify these important issues.

¹⁷ See item 10 in the "Draft Responses to CFTC Questions Concerning CFFE and NYBOC."

¹⁸ Proposed Rules 31 and 712.

¹⁹ See "Draft Responses to CFTC Questions Concerning CFFE and NYBOC" items number 10, 12, 28-30, 45, and 65.

²⁰ The practical difficulties in regulating persons beyond one's jurisdiction are illustrated in item 29 in the "Draft Responses to CFTC Questions Concerning CFFE and NYBOC." The Commission's staff asked: "Will the NYCE have any involvement in the authorization of the terminal operators? Please explain what role the NYCE will have in selecting or removing terminal operators?" The answer to these questions was: "The NYCE's compliance personnel will be able to remove Terminal Operators for compliance related reasons." Does this mean that the NYCE is limited to firing a terminal operator from CFFE (but not Cantor Fitzgerald Securities) for misconduct? More importantly, since the possibility of compliance violations is acknowledged, what if any authority will the Commission have over these non-registrants?

6. Conclusions and Recommendations

The proposed Cantor Fitzgerald Futures Exchange is a hybrid manual/electronic market operated by Cantor Fitzgerald Securities (a leading inter-dealer broker of Treasury securities) pursuant to an agreement with the New York Cotton Exchange. Cantor Fitzgerald Securities and its employees will be the exclusive access provider to the market and will provide the trading system for the market. Cantor and its employees, accordingly, are not merely service providers to the market, *they are the market*. We submit that as a public futures market the CFFE should be required to publish and enforce, rules governing the conduct of those who own and operate the Cantor system and control its access and data.

According to the CFFE Filings, neither Cantor Fitzgerald Securities nor its employees will be subject to the regulatory jurisdiction of the Cotton Exchange or the Commission's (apart from anti-fraud jurisdiction). This structure to our knowledge is unprecedented for a contract market, and we respectfully suggest that the Commission undertake the following actions to ensure that the public interest is appropriately served by the CFFE:

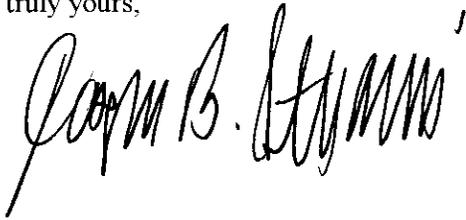
- The trading system and the persons operating it (e.g., Cantor Fitzgerald Securities, the Cantor system and the terminal operators) should be subject to the CFTC's oversight jurisdiction through registration as a regulated entity of some form (e.g., FCM, IB, contract market, associated person or floor broker). Such registration is necessary to ensure that the Cantor entities do not abuse their position as monopolistic access providers for the market through discriminatory pricing and service, and are subject to appropriate regulatory oversight with respect to trading practices.
- The trading system and the persons operating it should be subject to the jurisdiction of the New York Cotton Exchange so that the SRO responsible for the market is able to appropriately discharge its surveillance and enforcement responsibilities.
- Given concentration of market functions and the apparent gap in self-regulatory jurisdiction with respect to the Cantor Group, there is a particular need for the applicants to prepare and submit to the CFTC for review a written self-regulatory plan describing how they will ensure compliance with their rules and applicable Commission regulations. There also should be some provision in the plan for what would occur to the market and its participants if one of the entities in the Cantor Group were suspended as a result of its misconduct.
- The CFTC staff should conduct a detailed site inspection of the proposed terminal operator facility prior to designation to determine how the Treasury securities currently are traded at Cantor Fitzgerald Securities. We further suggest that the Commission should consider whether the terminal operators should be exempt from Commission registration as proposed in light of their activities and their role as exclusive access providers.

- The proposed By-Laws and rules of the CFFE regulating the conduct of terminal operators should be expanded to include the obligations and restrictions on the activities of such persons described in the other CFFE Filings so that these requirements are enforceable.

* * * * *

We appreciate the opportunity to comment on the CFFE Application and would be pleased to meet with the Commission or staff to further discuss our views.

Very truly yours,



cc: Hon. Brooksley E. Born, Chairperson
Hon. Barbara Pedersen Holum, Commissioner
Hon. David D. Spears, Commissioner
Hon. John E. Tull, Jr., Commissioner
Michael Greenberger, Director, Division of Trading and Markets
Alan Seifert, Deputy Director, Division of Trading and Markets
Jeffrey Arnow, Director, Division of Enforcement
Steven Manaster, Director, Division of Economic Analysis