



Thomas R. Donovan
President and
Chief Executive Officer

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April 30, 1999

Jean A. Webb
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street
Washington, D.C. 20581

COMMENT

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Re: Automated Boards of Trade

Dear Ms. Webb:

The Board of Trade of the City of Chicago ("CBOT") welcomes the opportunity to comment on the above-referenced proposal.

The CBOT does not oppose access from the United States for automated foreign boards of trade. However, the terms on which such access has been proposed would subject U.S. contract markets to an unacceptable competitive disadvantage.

I. Futures and futures options contracts traded on a foreign board of trade should not be traded electronically from the United States unless and until U.S. contract markets have regulatory parity.

As we understand the proposal, futures contracts could be traded electronically on a foreign board of trade which has not been designated as a contract market and which is not subject to the rules applicable to U.S. contract markets. Accordingly, these boards of trade would have lower regulatory costs than U.S. contract markets. Market participants are likely to find trading on these boards of trade to be cheaper and easier than trading on U.S. contract markets, and will encourage those boards of trades to list products already traded at overregulated U.S. contract markets. U.S. contract markets will be unable to respond.

We do not oppose the goal of enabling market participants located in the United States to access foreign boards of trade electronically. But regulatory parity for U.S. contract markets must be a necessary condition of that access. The Commission's exemptive authority under CEA §4(c) should be used to provide contract markets with regulatory parity.

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The Commission's proposal would exempt electronic foreign boards of trade from many of the requirements which govern U.S. contract markets; it would also permit practices which are prohibited on U.S. markets. This imbalance will effectively prohibit U.S. exchanges from offering products which compete with a product already listed by a foreign exchange. It will also encourage foreign exchanges to list the products of overregulated U.S. exchanges.

Before granting an electronic board of trade's petition under proposed Regulation 30.11, U.S. contract markets should have an opportunity to identify areas of regulatory disparity and to petition the Commission under section 4(c) for an exemption from the statutory or regulatory provision which is responsible for the disparity. Once the contract market's petition had been addressed, the foreign board of trade's petition could be granted. Moreover, the contract market would be able to file subsequent petitions if regulatory disadvantages emerged later.

The following summarizes areas in which U.S. contract markets would operate at a regulatory disadvantage with respect to exempted electronic boards of trade accessible from the United States.

1. Preapproval of Contracts, Contract Amendments and Rules. Contract market contract specifications have to be submitted to the CFTC for approval under Regulation 1.41(b). Even the so-called fast track procedure (CFTC Regulation 5.1) puts U.S. contract markets at an insurmountable disadvantage in bringing new products to market. Moreover, CEA §2(a)(8)(ii) provides that when a board of trade applies for contract market designation for futures on a security issued or guaranteed by the United States, the Department of the Treasury and the Board of Governors of the Federal Reserve Board have forty five days to review the application. In addition, the provisions of the Shad-Johnson Accord require contract market applications for stock index futures to be reviewed and approved by the Securities and Exchange Commission. In sharp contrast, an electronic board of trade operating in the United States under the proposed section 4(c) exemption would be able to list an identical product immediately. It has been shown repeatedly that the first product to market in an environment with regulatory parity has a virtually insurmountable competitive advantage. Where the first exchange to market enjoys a variety of regulatory advantages, competition would be even more difficult.
2. Account Identification. We understand that, unlike the requirement under which electronic U.S. contract markets operate, trades for customers can be entered on certain electronic boards of trade without account identification. If our hypothetical trader can make a trade ten seconds faster on the exchange which does not require these additional keystrokes, it is clear which exchange will receive his business.
3. Dual Trading. (Regulation 155.5(d)) Restrictions on dual trading are not applied to those who would trade electronically from the United States on an exempted board of trade. Those boards of trade would have no obligation to invest millions of dollars in audit trail technology and could use that money instead to improve system performance. Market participants will determine the relative value of a dollar spent on audit trail and a dollar spent on system performance quickly and clearly.

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4. Payment for Order Flow. Payment for order flow is part of the business strategy of some foreign boards of trade. If U.S. exchanges cannot counter competitive attacks based on such payments, the focus of liquidity is likely to move. Once moved, it cannot easily be recaptured. Payment for order flow is permitted in the securities industry if adequately disclosed (SEC Rule 11A(c)3-1) and can be received by commodity pool operators who disclose it under CFTC Regulation 4.23(j)(3). U.S. contract markets are not prohibited from paying for order flow in the United States. Nevertheless, Commission staff has balked at payments for marketmakers, suggesting that such payments might encourage wash trading. If this view is extended to payment for order flow, we will be at a significant disadvantage to our foreign competition.
5. Trade Practices. The CBOT is particularly concerned that an electronic board of trade would be able to allow its users to engage in trade practices which are not permitted under U.S. law. In some cases, users would be attracted by this opportunity, and would encourage the foreign board of trade to list contracts for which the Commission has already designated U.S. contract markets. In addition, if trading can be conducted on a contract market and an exempt electronic board of trade from the same terminal or the same window, it is likely that traders could become confused about trade practice rules at the different exchanges.

It is our understanding that foreign boards of trade may be subject to more relaxed rules regarding non-competitive trading, block trading and guaranteed order executions.

6. Costs of Maintaining Surveillance and Enforcement Mechanisms. Regulators in other countries do not enforce the self-regulatory obligations of exchanges as vigorously as the CFTC does in its periodic rule enforcement reviews. Obviously, the proposal doesn't provide for rule enforcement reviews of electronic boards of trade by the Commission. In fact, there is not even a process for reviewing the board of trade's compliance with its exemption order.
7. Large Trader Reporting. Traders on U.S. exchanges are required to provide daily reports of positions. Many such traders would transfer their business to foreign exchanges to avoid that disclosure.

The CBOT proposes that contracts traded on or subject to the rules of a contract market should be exempted under section 4(c) from the kinds of regulations described above.

II. An automated order routing system ("AORS") should not be subject to additional regulation if it can be used by customers in the United States to access any board of trade to trade non-U.S. based products.

A U.S.-based product is one (a) which is based on U.S. securities or interest rates; (b) which has one or more delivery points in the United States; (c) whose underlying cash market is located in the United States; or (d) which is denominated or settled in United States dollars.

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Second, if and when regulatory parity exists, customer orders for U.S.-based products offered by an exempted foreign board of trade could be entered on an AORS located in the United States.

The proposed regulation of AORS is vague and duplicative of existing Commission regulations. As long as the AORS is not used to enter orders for U.S.-based products, we see no reason to delay their use to access exempt foreign boards of trade.

III. The Commission should not expose U.S. exchanges to retaliatory regulation abroad. The Commission should not address the issue of regulatory disparity by imposing the requirements for U.S. contract markets on foreign boards of trade. This would invite retaliatory regulation abroad.

Although our initial efforts to expand abroad have been received with comparative hospitality by foreign regulators, the threat of retaliatory regulation is not idle. In the U.K., Project A's most successful foreign location, the Financial Services and Markets Bill is pending in Parliament to restructure the financial regulatory system. We have been advised that, if the bill is enacted, we will need to re-apply to the new regulator for recognition as an "overseas investment exchange." It is our understanding that a new application will be subject to the same standards that applied to our original application. However, following the publication of the proposal, U.K. regulators have expressed an interest in the application of IOSCO technical standards to U.S. contract markets.

IV. Conclusion

The CBOT welcomes competition when the same rules apply to the competitors. We urge the Commission to ensure that U.S. contract markets can compete on a fair and equal basis against foreign boards of trade in the United States.

Sincerely,



Thomas R. Donovan