

COMMENT

CHICAGO MERCANTILE EXCHANGE

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VIA FACSIMILE AND MAIL

October 22, 1999

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Ms. Jean A. Webb
Office of the Secretariat
COMMODITY FUTURES TRADING COMMISSION
1155 21st Street, N.W.
Washington, D.C. 20581

RE: Cantor Financial Futures Exchange's Proposal
to Adopt Block Trading Procedures

Dear Ms. Webb:

The Chicago Mercantile Exchange ("CME") is pleased to respond to the Commission's invitation for comments on the above subject. In January 1998, the Commission published a concept release concerning the regulation of noncompetitive transactions executed on or subject to the rules of a contract market. The CME commented on that concept release by letter dated April 28, 1998, taking the position that only an exchange that has a substantial share of the market for a particular contract should be allowed to introduce noncompetitive trading methods for such contract.¹ Our comments on the pending proposal submitted by the Cantor Financial Futures Exchange ("CX") are consistent with our previous position.

The Commodity Exchange Act ("Act") and Commission regulations generally require that futures contracts must be traded in an open and competitive manner. Regulation 1.38(a) provides that: "All purchases and sales of any commodity for future delivery, and of any commodity option, on or subject to the rules of a contract market shall be executed openly and competitively by open outcry or posting of bids and offers or by other equally open and competitive methods"

The "open and competitive" trading requirement is supported by compelling public policy considerations. Open and competitive markets are transparent, imparting price information to all market participants in a fair and even-handed manner. This supports price discovery, one of the key functions performed by futures markets. Because market participants have equal access to price information, they are willing to commit their capital to trading in such markets. The willingness of market participants to trade is a necessary ingredient for providing liquidity to the market.

¹It should be noted that 49 of the 60 comment letters submitted to the Commission generally opposed allowing noncompetitive execution procedures.

The CX submission to the CFTC cited, as a precedent for noncompetitive trading by a U.S. futures exchange, the CME's rule allowing all-or-none trading in certain contracts. All-or-none trading is intended to allow orders at or above a certain size to be executed in their entirety at a single price. Under the CME's rule, such orders must be bid or offered openly in the pit. Any floor broker or trader can hit the bid or take the offer for the entire quantity. Local traders who wish to participate in an all-or-none transaction can do so by having a floor broker aggregate their individual orders into a single bid or offer of the requisite size, which can be broken down and allocated to each of them after being executed as a single trade. All-or-none transactions are executed openly in full view of everyone in the pit, and the prices of such transactions are immediately reported and disseminated to market users around the world through the CME's quotation vendor network. As shown by the above description, the CME's all-or-none trading rule does not allow noncompetitive transactions. To the contrary, it provides an example of how large size transactions at a single price can be facilitated by open and competitive trading methods.

Unlike the CME's all-or-none trading rule, the CX proposal would allow trading that is neither open nor competitive:

- Block trades under the CX proposal would be privately negotiated between two counterparties. They would not be executed in an open market.
- The price of a block trade need not be within the bid/ask spread quoted in the regular market for that product.
- The price of a block trade is not immediately reported and disseminated. The CX proposal would allow the parties to a block trade to delay reporting it to CX for up to ten minutes from the time of execution. For a block trade that is executed during the last ten minutes of regular trading hours, the price need not be reported until the next business day.

If the CX proposal is approved, the consequences are easy to predict. A two-tier market will develop for block trades and regular trades. Large firms will be able to participate in both markets. Smaller entities, who trade in sizes smaller than block trades, will be limited to the regular market only. Whenever a block trade is executed at a price outside of the bid/ask spread in the regular market, a participant in the regular market (even with a resting limit order at a better price) will have lost out on an opportunity to obtain an execution at the price at which the block trade was executed.

As noted above, firms that participate in block trades are not required to report such trades for up to ten minutes. For that period of time, those firms have valuable market information that all other participants lack. Such firms can use that information to trade in other, related markets to the detriment of those who are at an information disadvantage. For example, assume that two firms execute a large block trade at a price substantially below the current bid/ask in the regular market. Once the information about the block trade becomes publicly known, the price in the regular market will go down. However, because the traders who participated in the block trade possess that information before it becomes publicly known, they can take advantage of such information by selling in the regular market before the information about the block trade is publicly reported.

Indeed, the mere possibility that this might occur is likely to demoralize participants in the regular market. From their perspective, they are subject to being "picked off" at any time by traders at large firms who have information about block trades that have not yet been publicly reported. Accordingly, participants in the regular market will be less willing to make bids or offers that might be picked off. This, in turn, will widen the bid/ask spread and reduce the liquidity in the regular market.

CX may be willing to jeopardize its own regular market in futures on Treasury bonds and notes because it has only a small share of the total market for those products. The Chicago Board of Trade ("CBOT") is clearly the primary futures market for those products. However, because many large firms are members of both CX and CBOT, the risk noted above that the CX block trading proposal might harm the liquidity in the regular market applies to the CBOT's market as well.

The CME is not opposed to block trading in all cases. In some situations, block trading might be necessary and appropriate. For example, in the Petition for Exemption pursuant to Section 4(c) of the Act that was recently submitted by the CME, CBOT and NYMEX, the three Exchanges asked for the ability to respond to competition from a foreign exchange authorized to place trading terminals in the U.S. by implementing trading rules and procedures comparable to those of the competing foreign exchange, provided that such rules and procedures shall apply only to contracts subject to direct competition from the foreign exchange. The CX proposal does not fall within the scope of the relief requested in that Petition because CX has pointed to no foreign exchange with trading terminals in the U.S. that offers a block trading facility for the contracts listed by CX.

In our previous comment letter dated April 28, 1998, the CME recognized that an exchange with a substantial share of the market for a particular contract could decide to adopt rules permitting noncompetitive trading of such contract. The exchange would have a strong incentive to ensure that such noncompetitive trading does not harm the liquidity of its regular market or increase the potential for manipulative activity. However, because CX does not have a substantial share of the market for the contracts that it seeks to include in its block trading proposal, this rationale offers no support to the CX proposal.

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In conclusion, the CME urges the Commission not to approve the CX proposal unless and until the concerns addressed in this letter have been alleviated.

Respectfully submitted,



Scott Gordon

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cc: Chairman William J. Rainer
Commissioner Barbara P. Holum
Commissioner David D. Spears
Commissioner James E. Newsome
Commissioner Thomas J. Erickson