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October 22, 1999

COMMENT

Ms. Jean A. Webb
Commodity Futures Trading Commission
Three Lafayette Center
1115 21st Street, NW
Washington, DC 20581

Dear Ms. Webb:

We appreciate the opportunity to respond to Cantor Financial Futures Exchange's Proposal to Adopt Block Trading Procedures.

In general, we support the Commodity Futures Trading Commission (the Commission) in its approach to evaluate each exchange's block trading proposal individually. We are also pleased to see that these proposals are being published for public comment. There are a number of factors that must be considered in each case and the effects of block trading on each contract market are likely to vary dramatically. Our recommendations, outlined below, center on the idea that the composition of the market participants is crucial. We believe that the desirability of block trading must be evaluated based on the effect that it will have on price discovery and the retail customers.

Background

Competition is having a dramatic impact on the futures industry and the financial markets in general. Exchanges vie for customers' orders against local and global non-traditional competitors, in a number of trading platforms. It is within this climate that Cantor Financial Futures Exchange (CX) is attempting to attract a certain segment of financial market participants, namely large institutional customers with a special unmet need, to a new block trading facility.

The CX proposal for block trading allows Exchange contracts to be negotiated between two qualified parties, outside the existing exchange mechanism and simply to be reported to the Exchange within 10 minutes. Traditionally, the Commission has not granted exceptions to the general principle articulated in the Commodity Exchange Act, that trades should be executed competitively in a centralized marketplace that has been designated as a board of trade. However, the Commission does have the authority to approve the process by which exchanges allow noncompetitive trading and after soliciting comments on alternative execution procedures

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in January of 1998[1], has released an Advisory on the subject.[2] In this Advisory, the Commission broadly endorses the concept of alternative procedures under certain circumstances and outlines the approach it will take in evaluating specific exchange proposals.

One of the factors the Commission will be examining in each proposal is a demonstration that the proposed transaction meets some need that the existing market cannot meet. CX submits that institutional customers have trading and hedging strategies that may be executed more effectively and efficiently by negotiating large transactions at a single price with a single counterparty. They argue that block trades cannot be executed via the traditional exchange mechanism, as the size of the order may disrupt the market and cause excessive price movements.

There are three main concerns preventing broad acceptance of alternative trading procedures. They are the negative effect on liquidity, transparency and price discovery. If a significant amount of the volume in a particular contract migrates outside the existing open-outcry or screen-based trading mechanism, then the liquidity of that system may be reduced. This may lead to greater bid/ask spreads and consequently greater transaction costs for the remaining participants. Of course, the effect on liquidity depends on whether or not the remaining order flow is sufficient to sustain the market. Furthermore, it depends on whether or not the new mechanism increases volume by attracting new customers (e.g. former over-the-counter customers) or simply fragments the existing market.

Similarly, if a large percentage of the transactions in a contract are occurring away from the market, price transparency may be reduced. Price information from the block trades may not be available in a timely manner for open-outcry or screen-based markets to incorporate into their own pricing models. Late disclosure of these transactions may not be useful in this sense. Although, if the block trading facility attracts former over-the-counter traders, whose transactions are not publicly disclosed, then despite the ten minute lag, transparency will increase.

Finally, the price discovery function of the exchange-traded markets may be adversely affected by the alternative trading facility. While reliable and fair market prices are desirable in all markets, they are particularly important in markets that do not have alternative sources of price information. Likewise, the price discovery element is critical to markets that are heavily populated by retail customers. These participants are less likely than wholesale participants to have access to other proprietary sources of information, are less sophisticated and are less likely to have the flexibility to trade a substitute contract.

<u>Analysis</u>
We recognize the difficulty is prescribing a specific formula to evaluate the costs and benefits of allowing block trading in futures markets. There are many factors that enter the equation and the market structure and practices that exist across exchanges are quite diverse. In an attempt to

[1] Commodity Futures Trading Commission Concept Release, "Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market", [63 FR 3708 (January 26, 1998)].
[2] Commodity Futures Trading Commission Advisory, "Alternative Executive, or Block Trading, Procedures for the Futures Industry", [64 FR 31195 (June 10, 1999)].

account for these differences, the Commission indicates in the Advisory that the effect of block trading on price discovery and competition on the markets will be factors in its deliberations. In practice, there appears to be difference in a market's reliance on price discovery based upon the composition of that market's participants. Therefore, we suggest that in order to assess properly the desirability of the CX proposal, as well as future proposals, a thorough analysis of the anticipated effects on liquidity, transparency and price discovery must be based on the type of participants active in the market. When retail interests are involved, a substantial loss of liquidity and a deterioration of the price discovery element will have a large negative impact. As mentioned above, these customers are less likely to have access to alternative pricing information and contract substitutes than are available in the over-the-counter market. In general, the CEA is designed to ensure that just such customers, who lack financial depth, expertise and information, receive fair and competitive prices in the market.

Conversely, if wholesale customers populate the market, the loss of liquidity and price discovery is not likely to have a debilitating effect on these participants. Their size and expertise afford them many options, just one of which is the alternative trading mechanism. This group of customers is less likely to fall prey to unfair or noncompetitive prices and has the means to seek recourse on such an occasion. In fact, bilateral trade arrangements are the predominant convention in many wholesale cash and over-the-counter derivatives markets. Regulatory intervention can therefore be minimized for this group of investors and block trading should be allowed.

In markets that are mixed, exchanges should demonstrate to the Commission that the benefits of block trading outweigh the costs. Exchanges could outline steps taken to mitigate potential negative consequences on liquidity and price discovery, factors that ultimately effect retail customers most significantly. For example, the contract specifications could be altered in such a way as to attract greater retail participation, thereby offsetting any loss in liquidity from fragmentation. It is the exchanges that are in the best position to produce innovative solutions to such problems. This is especially true, as no single prescription is likely to suit all contracts and all exchanges.

CX attempts to address potential negative liquidity effects by limiting the percentage of block trades. It intends to accomplish this with its rules prohibiting block trades between primary market makers and by increasing the minimum block size as volume in that contract increases. CX could minimize negative impacts on transparency by requiring block trades be reported to the Exchange in a shorter time-frame[3] and by specifying a limit within which CX will promptly post the trades for the rest of the market to see.

The Commission's greatest challenge is assessing the mixed-market case. It must estimate the effects of block trading on the whole market for a contract, not simply the effects on the petitioner's share of the contract or contracts in question. The Commission's evaluation of the market is further complicated by the global nature of some markets. Obviously, the petitioner will only have detailed information about the details of its market. For example, CX proposes a

[3] This may be especially true for block trades executed in the last ten minutes of trading or after the competitive market is closed. CX proposes that trades done during this window need only be reported to the Exchange prior to the next trading day.

minimum block size of 50 contracts. While fifty may represent a large block in relation to CX's average trade size and average daily volume, it certainly does not take into consideration the larger market for Treasury Bond futures. The Commission must consider the impact of this minimum threshold on the entire market.

Conclusion and Recommendation

Unfortunately, there is no easy rule for when to allow block trading. Certainly the bottom line is that the overall benefit must outweigh the cost, but these factors may be difficult to quantify and will surely differ across contracts and exchanges. It is reassuring however, that if an exchange wants to take advantage of the business opportunity to introduce a block trading facility, it will have the incentives to minimize negative effects on the market by innovating the contract rules. The Federal Reserve Bank of Chicago recommends that the Commission evaluate block trading proposals based on the ultimate effects on retail investors. In practice, it is generally this segment of market participants that relies on the transparent prices that emerge from the markets.

Thank you again for the opportunity to comment on this proposal. I hope you will find our suggestions useful. If you have any questions, my staff would be happy to discuss these issues further. Please feel free to contact Lisa Ashley at (312) 322-5750 or James Moser at (312) 322-5769.

Sincerely,

Michael H. Moskow