Exhibit A

Chicago Board of Trade

Thomas R. Donovan
President and
Chief Executive Officer

April 3, 1998

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

Re: **Application of Cantor Financial Futures Exchange, Inc. as a Contract Market in US Treasury Bond, Ten-Year Note, Five-Year Note and Two-Year Note Futures Contracts, 63 Federal Register 5505 (February 3, 1998)**

Dear Ms. Webb:

The Chicago Board of Trade hereby requests that the Commission extend the April 6, 1998 comment deadline on the above-referenced Federal Register release. The Commission has requested comments on the application for contract market designation submitted by a brand new exchange, the Cantor Financial Futures Exchange, Inc. ("CFFE"), in contracts that are nearly exact replicas of the Board of Trade's own Treasury futures contracts. The CFFE is seeking to offer these contracts under a wholly unprecedented exchange structure -- both in terms of organizational control and market operations -- that appears to be fundamentally at odds with the regulatory framework of the Commodity Exchange Act ("CEA") and Commission rules. It is difficult to fully evaluate the CFFE proposal, however, because there are major deficiencies in the information that CFFE has submitted to the Commission as part of its application.

We are requesting a sixty to ninety day extension to allow sufficient time for the Commission to request CFFE to provide additional necessary information, for CFFE to respond and for the Commission to make the information publicly available for interested parties to evaluate in formulating their comments. If the Commission encounters any delays in receiving more information from CFFE, it should suspend CFFE's application just as the Commission recently suspended FutureCom's application for contract market designation for FutureCom's failure to provide complete information necessary to adequately review its proposal. We have attached a list of the specific areas we have identified at this time where we believe the information provided in the CFFE application is deficient and needs to be supplemented.

An extension of the comment period is appropriate for other reasons as well. Based on the limited information that is available, CFFE's application raises fundamental regulatory questions. These include, among others:

1. Do the CFFE's proposed execution facilities meet the fair and competitive trading standards of the CEA and Commission rules?

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2. Is it in the public interest for Cantor Fitzgerald Securities Corp. to be given a monopoly on trade execution and to shield its activities from regulatory scrutiny by performing those functions under the rubric of contract market operations?

3. When exactly is a trade deemed to occur on the CFFE execution facilities and does the CFFE have an audit trail that accurately captures this information and other required audit trail information?

4. Will the CFFE's execution facilities have a detrimental effect on the price discovery function which Congress has declared to be in the national interest?

5. Will CFFE, through market fragmentation and unfair competition, harm the liquidity and price discovery of established government securities futures markets?

6. Should a Cantor-related company be allowed to control a federally-designated contract market given that one of the Cantor entities reportedly settled fraud charges recently with the CFTC and given the serious, unresolved allegations regarding questionable trading practices at several Cantor entities?

7. Does CFFE meet the statutory requirements for designation as a contract market?

The Commission's sixty-day comment period simply does not give interested parties enough time to undertake the type of careful and thoughtful evaluation of the CFFE's application that these complex issues dictate. In reality, the Board of Trade and, we assume, other interested parties have had even less time to evaluate the limited information CFFE has provided. In the Board of Trade's case, the Commission did not provide us with any substantive materials describing CFFE's proposed organization and operations until February 27, leaving the Exchange barely thirty days to formulate our comments.

Moreover, based on the limited information available, it appears that many of the issues raised by the CFFE application are inextricably tied to the market fragmentation issues raised by the Commission in its separate "Concept Release on Regulation of Noncompetitive Transactions Executed on or Subject to the rules of a Contract Market" ("Non-Competitive Trading Concept Release"), which was published for comment on January 26, 1998. The Board of Trade believes the Commission will receive more meaningful comments if interested parties have an opportunity to review and formulate comments on the two releases concurrently. Thus, at the very least, the Commission should extend the comment deadline on the CFFE application to April 27 to correspond to the comment deadline for the Non-Competitive Trading Concept Release.

For all of the reasons explained above, the Board of Trade urges the Commission to extend the comment deadline on CFFE's application for contract market designation by sixty to ninety days. We look forward to the Commission's prompt response to our request.

Sincerely,

Thomas R. Donovan

Thomas R. Donovan

LIST OF AREAS WHERE ADDITIONAL INFORMATION IS NECESSARY

The Board of Trade requests additional information in the following areas to enable the Commission and interested parties to fully and carefully evaluate the CFFE application.

Ownership/Control of CFFE

1. Description of the level and source of capitalization of Cantor Financial Futures Exchange Holdings, L.L.C, ("Holdings") including any debt arrangements between CFFE and Cantor Fitzgerald & Co. ("Cantor") or its affiliates

2. Organization chart illustrating the relationship between CFFE; Holdings; Cantor; CFFE, LLC and other Cantor entities, including percentage ownership

3. Description of the nature and level of financial interest corresponding to direct or indirect ownership that Cantor or any of its affiliates has in CFFE

4. Description of the nature and amount of any other financial compensation that Cantor or its affiliates will receive from CFFE for participating in or performing services for CFFE; e.g., whether Cantor Fitzgerald Securities Corp. ("CFS") will receive any compensation for providing employees to act as Terminal Operators

5. Identity of investors and controlling entities in CFFE, LLC

6. Identity of CFFE's initial board of directors and officers

7. Identity of each individual and entity previously disciplined by the SEC or CFTC that is involved in the direct or indirect ownership or management of the CFFE; and a copy of all publicly available information regarding the nature and disposition of those proceedings

Ownership/Control of the New York Board of Clearing, Inc. ("NYBOC")

8. Description of the level and source of NYBOC's capitalization

9. Description of NYBOC's financial safeguards to ensure the financial stability of the clearing system; description of the level and source of NYBOC's financial resources available to cover a clearing member default, including a description in each case of whether the resources are liquid or illiquid; and a description of NYBOC's default procedures

10. Identity of NYBOC's initial board of directors and officers

Exchange Personnel

11. Description of Terminal Operator qualifications and responsibilities, as well as any restrictions on their activities as Terminal Operators, e.g., whether Terminal Operators are

allowed to solicit futures orders or government securities orders for CFS or other Cantor affiliates

12. Description of how Terminal Operators will be compensated and by whom

13. Since Terminal Operators are also employees of CFS, a description of their job responsibilities for CFS, including whether they will handle customer orders in government securities for CFS or may trade for CFS's account

14. Description of the functions that Terminal Operators will perform that require registration with the NASD as Government Securities Representatives

15. Information regarding compensation of Terminal Operators for non-CFFE activities they will perform for CFS or any other Cantor affiliates

16. Information regarding qualifications, responsibilities and authority of the persons designated as supervisors ("Supervisors") over the Terminal Operators

17. Description of how Supervisors will be compensated and by whom

Trading Activities/Rules

18. Description of any trading activities that Cantor, CFS or any other Cantor affiliates are permitted to conduct, either proprietary or for customers, on the CFFE

19. Description of any restrictions on trading activities of Terminal Operators and Supervisors in other markets or on behalf of Cantor, CFS or other Cantor affiliates or their customers

20. Description of any cash market activities of any Cantor entities that will have access to CFFE trade information

21. Description of any procedures to prevent improper flow of confidential or sensitive trade information between CFFE, on the one hand, and Cantor, CFS and other Cantor affiliates, on the other hand

22. Description of the execution process, from a member's receipt of a customer order; to placing of the order with a Terminal Operator; through the Terminal Operator's handling of the order, including especially the Terminal Operator's role in the execution process during the "Exclusive Time" and the "Clearing Time;" through communication of an executed trade back to the customer

23. Description of the current execution facilities and processes at CFS and other Cantor entities and a point by point comparison of the same to CFFE's execution facilities and processes, including a comparison of existing work up practices to the Exclusive Time concept at CFFE

24. Description of any CFFE rules or restrictions on block trading, that is, matching of trades away from the CFFE's execution facilities

25. Description of any CFFE rules or restrictions on pre-negotiation, i.e., pre-arrangement of orders that are submitted to the Terminal Operators

26. Description of any CFFE rules or restrictions on dual trading

27. Related to dual trading and insider trading concerns, a description of any CFFE rules or restrictions on Cantor, CFS or their affiliates participating in CFFE's markets given CFFE, LLC's control over CFFE and the Terminal Operators' status as joint employees of the CFFE and CFS

28. Description of how the CFFE's trade practice rules and execution facilities meet competitive trading standards

29. Explanation of when a trade is deemed to occur

Audit Trail and Surveillance Procedures

30. Description of the audit trail information that CFFE will capture throughout the entire end-to-end cycle and how -- e.g., whether Terminal Operators will time stamp orders when received or at other steps in their handling of orders; whether audit trail information will include time of trade execution; whether it will include any special audit trail information with respect to the Exclusive Time or Clearing Time trade procedures

31. Description of the accuracy and reliability of CFFE's audit trail information and how CFFE's audit trail complies with the CEA and CFTC requirements system or any audit trail specific to an electronic environment (including during Exclusive Time and Clearing Time)

32. Description of the surveillance programs that the New York Cotton Exchange ("NYCE") will perform for CFFE and whose activity will be covered, e.g., whether NYCE will conduct surveillance of how the Terminal Operators handle and execute the orders they receive

33. Description of NYCE's surveillance programs for monitoring activity that occurs on the electronic component of CFFE's execution facilities

34. Description of NYCE's surveillance programs for monitoring EFP or basis trading

35. Description of any special market or trade surveillance functions that NYCE will perform with respect to the trading activities of the Terminal Operators or Supervisors in other markets, whether for their own account or on behalf of Cantor, CFS or other Cantor affiliates or their customers

36. Description of any special market or trade surveillance functions that NYCE will perform with respect to the trading activities of Cantor, CFS or other Cantor affiliates, whether as dealer for their own account or as broker on behalf of other customers

37. Demonstration that NYCE has adequate resources to take on added surveillance responsibilities on behalf of CFFE

Customer Grievances

38. Description of customer recourse against CFFE for trading errors committed by Terminal Operators; justification for any disclaimers of such liability by CFFE in light of Commission requirements that exchanges provide an arbitration forum for customer grievances against exchange members, which includes grievances relating to trading errors or abuses

Integrity of the CFFE Trading System

39. Description of whether CFFE has tested the accuracy and reliability of the electronic component of CFFE's execution facilities trading system, whether the testing was performed and the test results certified by a qualified independent consultant; and the results of any such testing

April 27, 1998

Ms. Jean Webb
Secretary
Commodity Futures Trading Commission
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Washington, D.C. 20581

Re: **Application of Cantor Financial Futures Exchange, Inc. as a Contract Market in U.S. Treasury Bond, Ten-Year Note, Five-Year Note and Two-Year Note Futures Contracts, 63 Federal Register 5505 (February 3, 1998)**

Dear Ms. Webb:

The Board of Trade of the City of Chicago ("CBOT" or "Exchange") appreciates the opportunity to submit our comments on the application (the "Application") filed by the New York Cotton Exchange and various Cantor Fitzgerald-related entities (the "Applicants") for designation as a contract market in various government securities futures contracts, which the Commodity Futures Trading Commission ("CFTC" or "Commission") published for comment on February 3, 1998. The Applicants are proposing to establish a new futures exchange, the Cantor Financial Futures Exchange, Inc. ("CFFE"), under a wholly unprecedented structure in terms of organization and market operations. The Board of Trade opposes that application on multiple grounds.

Public review of and comment upon the Application has been hindered by major deficiencies in the information that is available. We urge the Commission to require the Applicants to supplement their Application in the many areas identified in this comment letter.[1] Further, the Commission should suspend its consideration of the materially incomplete Application until the Applicants provide the missing information, just as the Commission recently suspended FutureCom's application for contract market designation for incompleteness.[2]

Even the limited information available on the Application demonstrates that CFTC approval of CFFE would constitute arbitrary and capricious agency action. For example, the CFFE would

[1] On April 3, 1998, the Exchange requested an extension of the comment deadline and asked the Commission to require the Applicants to provide additional essential information for evaluating the Application. Although the Commission granted a limited extension, no additional information has been made available to answer the many questions the Exchange has raised. The areas of deficiency covered in this letter include those identified in our April 3rd request.

[2] See, Letter from the John C. Lawton, Associate Director, Division of Trading and Markets, to Mr. William H. O'Brien, FutureCom (March 24, 1998) (suspending consideration of Futurecom's application). Many of the deficiencies that the Commission cited in FutureCom's application permeate the CFFE Application.

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violate Commission Regulation 1.38. That rule requires that transactions on any contract market must be executed "openly and competitively." Yet the Application and CFFE promotional materials concede that, in at least two sets of circumstances, the CFFE system will regularly exclude all traders but two from trading. That process would be akin to an exchange's allowing two members to trade exclusively between themselves in a trading pit, and secretly, while all others in the pit would be forced to stand mute. That is not open and competitive trading. That is closed and monopolistic trading. CFFE's trading system therefore is inherently incompatible with federal law and must be rejected by the Commission for this reason alone.[3]

The CFFE application also compromises other basic tenets of CFTC regulation: market surveillance, customer protection, efficient price discovery and hedging, avoiding market fragmentation, unfair competition, fitness standards for those who control federally-licensed exchanges, audit trails, dual trading, conflicts of interest, diversity on exchange boards, customer grievance procedures, registration of trading professionals and trading standards. Compounding these fundamental deficiencies, the application is designed to place order entry and trade execution systems completely beyond the regulatory reach of both the Commission and the new exchange. The CFTC should not tolerate this pervasive disregard for its jurisdiction and regulatory regime.

The CBOT has thrived on competition for 150 years. However, we are against unfair competition. The CFFE would constitute a proprietary exchange beholden to one powerful market participant that would be unaccountable under accepted regulatory standards and would have the power to damage the integrity of our markets. Our concerns are heightened by the fact that this party would control a federally-licensed exchange despite having settled fraud and other charges that, under applicable CFTC rules, would prevent an individual from sitting on an exchange's board or serving as a member of a disciplinary committee. In this regard, we agree with the statement by Vanderbilt University Finance Professor, Hans Stoll, who commented regarding the CFFE that "electronic trading does not pose major new risks for investors," but "any new electronic market will depend on the integrity and financial soundness of the people running it."[4]

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[3] The Commission has undertaken in a separate analysis of issues relating to non-competitive trading, such as block trading, on designated contract markets. At the very least, action on the CFFE Application should be delayed until the issues addressed in that release have been resolved. See, Concept Release on Regulation of Noncompetitive Transactions Executed or Subject to the Rules of a Contract Market, 63 Fed. Reg. 3708 (Jan. 1998) ("Concept Release").

[4] "Cantor, Cotton Exchange Ask CFTC for Bond Futures Trading Power," Bloomberg Business News, March 11, 1998.

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Our comments are organized in the following manner:

I. Proposed Structure & System - Unprecedented Proprietary Exchange Model
   - A. Exchange Structure - CFFE, NYBOC and Cantor[5]
   - B. Trading Operations: Replication of Cantor's Broker Facilitated, Screen-Based Trading System
   - C. Customer Protection Concerns: Potential for Favoritism and Abuse

II. Issues Regarding Cantor's Fitness to Control a Federally-Licensed Exchange

III. Analysis of CFFE Under CEA and Commission Requirements
   - A. Trading Standards
   - B. EFPs
   - C. Surveillance and Audit Trail
   - D. Risk Disclosure
   - E. Customer Grievance Procedures
   - F. Non-Compliance with Diversity Standards
   - G. Dissemination of Market Data
   - H. Public Interest Considerations: Price Discovery, Market Fragmentation, and Unfair Competition

IV. Clearing Uncertainties

V. The Commission Cannot Legally Approve the Application in its Current Form

VI. Questions/Areas Where Additional Information is Needed

VII. Conclusion

I. Proposed Structure & System - Unprecedented Proprietary Exchange Model

Determining how the new CFFE will operate is confusing given the incomplete factual record that has been made publicly available. But some factual frame of reference is needed in order to analyze whether CFFE would comply with specific provisions of the CEA and Commission rules. Despite the deficiencies in the record, the Exchange has been able to piece together a description of how the

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[5] We use the term "Cantor" to refer to the group of related entities which are under the common control of Cantor Fitzgerald, L.P. See, organization chart attached as Exhibit A to this letter.

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CFFE would operate. Based on that understanding, Cantor would appear to play an unprecedented and highly conflicted role in the operation of the CFFE.

Before turning to a detailed description of CFFE's operations, certain conceptual distinctions between CFFE and existing contract markets must be highlighted:

1. CFFE is a proprietary exchange controlled by Cantor, a private brokerage business, and there is no clear delineation between CFFE's and Cantor's operations, or any explanation of Cantor's compensation for providing the computer system, personnel and other services to the CFFE. Cantor will appoint 8 of the 13 members of CFFE's governing board, although Cantor will not be an equity owner of CFFE, and although Cantor affiliates may engage in trading on CFFE.

2. Cantor will be given a monopoly over trade execution. Only Cantor's employees, who are dually employed by the CFFE, can execute trades and access the CFFE electronic bulletin board dubbed its trading system.

3. The CFFE structure and rules will afford Cantor and its employees immunity from regulatory oversight and discipline by both the CFFE and the Commission, because the trading activities that they perform are improperly categorized as management and operation of a contract market.

4. Cantor and its employees assigned to CFFE will circumvent registration requirements and fitness standards that apply to floor brokers and futures commission merchants even though they will be performing many of the same execution activities as those market professionals.

5. CFFE is not an electronic trading system for futures contracts. The CFFE's execution facilities are designed to replicate Cantor's existing brokerage operations and represent a hybrid between voice and electronic execution that will be performed in a back room environment resembling a non-public trading pit.

6. The CFFE incorporates closed and exclusionary cash market trading conventions that are the antithesis of open and competitive trading required for designated contract markets.

Simply put, the CFFE structure will allow Cantor to control the exchange, and trading on the exchange, for its own benefit and without proper accountability. No exchange can provide market integrity and enforce equitable procedures when one entity has control over the exchange, participates in the exchange's markets, and maintains a monopoly on the exchange's execution functions. Strict separation of these duties has been the norm to ensure effective management and control of the public risk transfer and price discovery processes.

While the foregoing characteristics may be gleaned from available information, our picture of the CFFE is still incomplete and we have many more specific questions. As shown in the organization

charts attached at Exhibits A and B, we do not know all of the connections among the CFFE, Cantor and NYBOC. We have no true picture of the capitalization and other financial incentives among the interested parties and their personnel. The description of the roles of exchange personnel and their activities is vague. We also have no meaningful information about how audit trail and surveillance will be performed to ensure that customer abuses will be prevented. We also have very little information about the clearing of CFFE transactions, including the New York Board of Clearing's requirements for clearing members and financial standards and protections.

This letter discusses our concerns with the CFFE's approach in detail. However, given the unprecedented structure, questions about Cantor's disciplinary history, and the lack of critical information, we would request an open public hearing, preferably an "on the record hearing," so that all interested parties can gain an accurate understanding of Cantor's proposal. Once the Commission has developed a complete factual record, it should republish the Application for further public comment.

The Commission should also defer acting on the CFFE proposal until it has developed its general regulatory approach with respect to alternative trading systems. In this regard, the Securities and Exchange Commission ("SEC") recently undertook a broad study of alternative trading systems to develop a general approach for their regulation and to avoid piecemeal treatment of of such systems. The SEC historically took a case-by-case approach to try to harmonize the regulation of traditional exchanges and alternative trading systems but this contributed to considerable confusion. In recent years, however, the SEC has revived efforts to replace the case-by-case approach with generally applicable rules for alternative trading systems coupled with regulatory relief for exchanges that, "fac[e] increasing competition from overseas and over-the-counter markets."[6] The SEC's experience shows that the case-by-case approach leads quickly to regulatory anomalies and should not be followed by the CFTC.

A. Exchange Structure - CFFE, NYBOC and Cantor

To the extent they can be identified, the interrelationships among the CFFE, Cantor, the New York Cotton Exchange ("NYCE") and the New York Board of Clearing, Inc. ("NYBOC") are set forth in the organization charts attached as Exhibits A and B. The charts reveal significant connections between Cantor, NYCE, the CFFE and NYBOC. The CFFE is a New York not-for-profit corporation which is wholly-owned by Cantor Financial Futures Exchange Holdings, LLC ("Holdings"). Holdings is a limited liability company with two classes of membership, Class A and Class B. The NYCE has a 10% Class A interest in Holdings, and full members of the NYCE will

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[6] See, "Regulation of Exchanges and Alternative Trading Systems," Sec. Rel. 34-39884, File No. S7-12-98 (April 17, 1998).

be offered the opportunity to become Class B members in Holdings. Class B members will have no voting or management rights in Holdings.[7]

Holdings is the only stockholder of the CFFE and its only "member". However, a wholly-owned subsidiary of Cantor Fitzgerald, L.P., CFFE, LLC, has the right to appoint eight of CFFE's thirteen directors.[8] There is no explanation of why Cantor is given this control. No information is provided regarding the capitalization of the CFFE, Holdings or CFFE, LLC. It is unclear whether Cantor is providing any capital to CFFE that would explain why CFFE, LLC is permitted to appoint a majority of the CFFE's board, and why Cantor's name is so prominently included in the name of the new exchange. It appears that Cantor will have at least an indirect financial interest in CFFE because it will receive a transaction fee for each trade executed at CFFE through the Cantor System.[9] The amount of this fee is unknown.

The CFFE's Cantor-controlled board will appoint many important committees for the CFFE,[10] including the Futures Committee, which oversees settlement prices for CFFE contracts,[11] and the Committee on U.S. Treasury Securities, which has the authority to specify when the closed and noncompetitive Clearing Time and Exclusive Time trading sessions (described in the following section on Trading Operations) will occur for the CFFE's proposed Treasury futures contracts.[12] The Committee on U.S. Treasury Securities also specifies when Market Crossing sessions will occur.[13] The CFFE's Cantor-controlled board has authority for adopting CFFE rules and rule amendments (which are also subject to approval by the NYCE board). The CFFE's Cantor-controlled board is authorized to take emergency action on behalf of the exchange[14] and also has broad authority, set forth in CFFE Rule 300(c), "in its discretion, without previous notice, [to] close CFFE or any contract market thereof on such days or portions of days as will in the Board's . . . judgment serve

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[7] CFFE Draft By-laws and Rules (1/6/98) ("CFFE Draft By-laws"), Section 35(b).

[8] CFFE Draft By-laws, Section 1. Three of the eight Cantor appointees are supposed to be public directors, but they may be customers or agents of Cantor.

[9] 63 Fed. Reg. 5505 (February 3, 1998).

[10] CFFE Draft By-laws, Section 14.

[11] CFFE Draft By-laws, Rule 314.

[12] CFFE Draft Rules on U.S. Treasury Securities Futures Contracts ("CFFE Draft Treasury Futures Rules"), Rule 832.

[13] Id., Rule 833.

[14] CFFE Draft By-laws, Rule 36.

to promote the best interest of CFFE."[15] The Applicants offer no explanation for why Rule 300(c) contains this separate grant of authority to the Board.[16] The Commission should insist that the Applicants explain why they have included this provision and describe other circumstances beyond emergencies when the CFFE Board could take the extraordinary action of closing CFFE markets without notice.

Cantor Fitzgerald Securities, LLC, a wholesale broker-dealer of government securities and a wholly-owned subsidiary of Cantor Fitzgerald, L.P. Cantor Fitzgerald Securities, LLC, will provide the CFFE with individuals called "terminal operators" ("Terminal Operators"). Terminal Operators will be joint employees of Cantor and CFFE. Terminal Operators will perform the trade entry and execution functions for the exchange through a joint employment agreement with Cantor Fitzgerald Securities and the CFFE. The NYCE has agreed to perform all surveillance functions for the CFFE.[17]

All clearing for the CFFE will be accomplished through the NYBOC. NYCE controls NYBOC through its ownership of the Commodities Clearing Corporation, which is the sole shareholder of NYBOC. NYBOC's ten directors will be elected by the Commodities Clearing Corporation. NYBOC will be capitalized through Clearing Member contributions to a Guarantee Fund.[18] The Applicants have provided no information on their projections for the capitalization of the Guarantee Fund. The Commodities Clearing Corporation does not provide any guarantee of NYBOC's financial obligations on trades it accepts for clearing and settlement.[19] The Commodities Clearing Corporation has been discussing establishing a cross-settlement and cross-margining arrangement between NYBOC and the Government Securities Clearing Corporation since last Fall.[20]

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[15] CFFE Draft By-laws, Rule 300(c).

[16] Draft Responses to CFTC Questions Concerning CFFE and NYBOC accompanying November 5, 1997 submission (the "Draft Responses"), p. 17 at Question 37(a). The Applicants suggest that the CFFE board's authority under CFFE Rule 300(c) is the same as its emergency authority under CFFE Rule 36, but if the authority is the same, why is Rule 300(c) necessary? It appears that the Applicants intend to rely on Rule 300(c) for some additional authority beyond emergency authority but are seeking to downplay that possibility.

[17] Draft Responses, p. 10 at Question 13.

[18] Draft Responses, p. 27 at Question 76.

[19] Draft Responses, p. 27 at Question 77.

[20] See, Letter from Jeffrey Ingber, General Counsel and Secretary, Government Securities Clearing Corporation, to Ms. Jean A. Webb, Secretary, Commodity Futures Trading Commission (April 8, 1998).

Cantor Fitzgerald & Co. plans to become a Clearing Member, as defined in the CFFE rules,[21] but we do not know the identities of the other potential Clearing Members or the standards of approval for clearing membership. However, we assume that many CFFE Clearing Members will be existing customers of Cantor in the cash market.

It is unclear whether, or how, the relationships described above will be affected by the pending merger of the NYCE and the Coffee, Sugar and Cocoa Exchange. For example, it is unclear whether NYCE will maintain its own staff to perform surveillance functions for the CFFE, and whether the membership structure of Holdings will be revised to admit members of the Coffee, Sugar and Cocoa Exchange.

B. Trading Operations: Replication of Cantor's Broker Facilitated, Screen-Based Trading System

The CFFE's trading operations appear to be carefully designed to replicate Cantor's voice brokerage activities in the securities markets. Cantor uses a combination of voice broker negotiations supported by an electronic, screen-based system that resembles a bulletin board in its cash trading activities. Cantor will run a similar trading room operation for the CFFE. Cantor will supply both the brokers (the Terminal Operators) who will execute the orders placed on the CFFE and the electronic system (the "Cantor System") that will support their trading activities. Orders will not be executed or matched electronically on the Cantor System. Instead, this form of electronic bulletin board system requires affirmative action to lift an offer or hit a bid. The CFFE incorporates exclusionary cash market work up conventions that are per se incompatible with the "open and competitive" trading standards that apply to the futures markets under federal law. This section describes each participant and its role in the CFFE's trading operations followed by a description of the order entry and trade execution process, market crossing procedures and EFP's.

1. The Participants

The chart attached as Exhibit C illustrates trading access to the CFFE, where direct access is limited to Clearing Members, Screen Based Traders and Authorized Traders, and execution is performed by unregistered "Terminal Operators". The Applicants have attempted to obscure the true nature of the roles performed by the various participants through careful packaging and mislabeling.

(a) **Terminal Operators.** Terminal Operators are analogous to floor brokers. Each futures contract on the CFFE will be supported by multiple Terminal Operators. The Terminal Operators are authorized by the CFFE to accept orders by telephone from Authorized Traders and to arrange for their execution on the Cantor System.[22] Although it is not entirely clear, it appears that

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[21] Draft Responses, p. 4 at Question 12.

[22] CFFE Draft By-laws, Rule 31; Draft Responses, p.14 at Question 28.

only "Clearing Members". "Screen-Based Traders" and their "Authorized Traders", all described below, may phone a Terminal Operator directly to place an order on the CFFE. The Terminal Operators will perform their functions in a trading room environment that resembles a trading pit on an exchange floor except that the environment is non-public. The Terminal Operators appear to be pulled from Cantor's base of NASD-registered Government Securities Representatives.[23] They are assigned by Cantor Fitzgerald Securities and will be jointly employed by Cantor Fitzgerald Securities and the CFFE. Presumably, the Terminal Operators are graduates of Cantor's four-month training program for brokers.[24] Although they are registered under the federal securities laws, the Terminal Operators will not be registered in any capacity under the CEA. Their NASD registration implies that Terminal Operators will be allowed to transact business in the cash market for U.S. Treasuries with the same customers who call in futures orders.[25] We do not know how Terminal Operators are compensated, including whether they will receive any incentive fees. The attempt to characterize the Terminal Operators' functions as "clerical" is a vivid example of the mislabelling at which the Applicants excel.

(b) **Clearing Members.** All trades on the CFFE must be cleared and guaranteed by Clearing Members. The CFFE rules define a "Clearing Member" as a partnership or corporation authorized by the CFFE and the NYCE to act as a Clearing Member on the NYCE.[26] Very little information has been given on the eligibility for clearing membership. We believe that the Applicants intend for NYCE clearing members (of the Commodities Clearing Corporation) to be eligible as clearing members of NYBOC.

(c) **Screen-Based Traders.** According to the CFFE rules, a "Screen Based Trader" is a person that is registered as a Futures Commission Merchant ("FCM"), an Introducing Broker, a Commodity Trading Advisor, or a Floor Trader or Floor Broker of the NYCE and that has a written agreement with a Clearing Member pursuant to which the Clearing Member will clear and guarantee such person's trades on the CFFE. The CFFE Rules imply that Screen-Based Traders and other persons with direct access to Terminal Operators must be approved for "trading privileges" on the CFFE, although this is not entirely clear.[27] According to the Applicants, Screen-Based Traders

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[23] See, Draft Responses, p. 3 at Question 10.

[24] For Cantor's description of its training program, see, Cantor's Website, http://www.cantor.com.

[25] At the very least, they will receive and in some way handle orders for EFP transactions involving U.S. Treasury futures and cash Treasury securities. CFFE Marketing Materials, p. 3. Issues regarding the role of the Terminal Operators in EFP transactions are discussed in subpart 6 of this section.

[26] CFFE Draft By-laws, Rule 12.

[27] CFFE Draft By-laws, Rule 36. The persons eligible for trading privileges described in clause (b) of this rule correspond to the persons covered by the definition of Screen-Based Trader in Rule 29, although Rule 29 does not expressly state that Screen-Based Traders must be approved for trading privileges. The real issue is what is meant by

initially will be limited to natural persons. The definition also covers entities in case the CFFE decides to move to computerized trading in the future.[28]

(d) **Authorized Traders.** Clearing Members and Screen-Based Traders will place orders with the Terminal Operators through their Authorized Traders. As defined in the CFFE Rules. Authorized Traders are natural persons "authorized by" or "having apparent authority" from a Clearing Member or Screen Based Trader to telephone a Terminal Operator with requests to post or accept bids and offers on the Cantor System.[29] The Applicants imply that an Authorized Trader would be affiliated with the Clearing Member or Screen-Based Trader that designates him.[30] However, the definition could be interpreted to allow Clearing Members and Screen-Based Traders to designate employees or agents of their customers as Authorized Traders and thereby provide outside customers with direct telephone access to Terminal Operators. The Commission should clarify the Applicants' intentions regarding who may be an Authorized Trader to have a better understanding of the likely dynamics that will exist in the relationship between Terminal Operators and Authorized Traders. It is also important to understand whether customers will exercise "trading privileges" on the CFFE without the equivalent of "membership approval" that would bring them under the self-regulatory jurisdiction of the CFFE.

(e) **Customers.** A customer is defined in the CFFE rules as "a person for whom a Clearing Member or Screen Based Trader carries an account or from whom any Clearing Member or Screen Based Trader solicits or accepts any order to effect any transaction" on the CFFE.

(f) **Cantor Fitzgerald & Co.** According to the Applicants, Cantor Fitzgerald & Co. will become a Clearing Member of NYBOC with "similar" rights as non-affiliated members of the CFFE to trade on the CFFE.[31] Thus, presumably, Cantor Fitzgerald & Co. will be able to designate Authorized Traders who may place orders directly with the Terminal Operators, either for Cantor's own account or for customers.

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the term "trading privileges". Are trading privileges the right to contact a Terminal Operator directly to place an order? If so, then presumably only those approved for such privileges may directly place orders on the CFFE through their Authorized Traders.

[28] Draft Response, p. 13 at Question 24 ("While fully computerized trading on the CFFE may be introduced at a later stage, a non-person does not qualify as a Screen Based Trader upon the start of trading on the CFFE.")

[29] CFFE Draft By-laws, Rule 4. No meaningful guidance is provided on how to determine "apparent authority" in this context.

[30] See, Draft Responses, p. 12 at Question 20 ("Each Authorized Trader that will be acting for a customer will be registered with the Commission in the appropriate capacity. Employees of Screen Based Traders or Clearing Members who act exclusively in proprietary capacities need not be registered.")

[31] See, Draft Responses, p. 4 at Question 12.

(g) **Cantor Error Account.** Cantor will establish an affiliate for the purpose of maintaining an error account for Terminal Operator trading errors.[32] Presumably, this undisclosed Cantor entity will become a Clearing Member. Cantor Fitzgerald & Co. will guarantee this Cantor entity.[33] Error accounts may be established for the legitimate purpose of taking trading errors into a house account. However, they also offer the potential for abuse by providing a means of covertly taking into an error account favorable customer trades that were not executed in error. Cantor has reportedly used its own house accounts on some occasions to trade against customers.[34]

(h) **Other Cantor Entities.** There are many Cantor-affiliated companies. The employees of only two of these entities, however, are expressly precluded from being physically present in the "pit" location with the Terminal Operators: the entity holding the Cantor Error Account and Cantor Fitzgerald & Co. There is no similar restriction against employees of other Cantor entities, including employees who trade in the cash market, from being physically present, raising concerns about how CFFE plans to protect against disclosure of confidential trading activity on its markets. The Applicant's only assurance is that "no Cantor Fitzgerald Entity will conduct any proprietary trading on the CFFE in *government securities*."[35] However, that statement does not preclude trading in *futures* on the Cantor System or government securities on other systems by Cantor employees, potentially in the same room and with physical proximity.

2. CFFE Trade Execution: Voice Negotiation Supported by an Electronic Bulletin Board

In an apparent attempt to create an aura of reliability and integrity for the Cantor System, the Applicants have fostered the misleading impression that the Cantor System is an electronic trading system akin to automatic trade matching vehicles that other contract markets offer. In fact, the CFFE does not propose a computerized system for automatic matching of customer orders.[36] The Cantor System is an electronic bulletin board that relies on Cantor's existing voice broker network to

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[32] CFFE Draft By-laws, Rule 308(b).

[33] Draft Responses, p. 4 at Question 12.

[34] See, Thomas Jaffe, "Between the Wall and the Wallpaper," Forbes, October 20, 1997, attached as Exhibit D to this letter.

[35] Id., emphasis added.

[36] CFFE Draft By-laws, Rule 303-A. Orders may be automatically matched during "Market Crossing" sessions to the extent that such sessions are observed for a particular contract. See subpart 6 of this section for a description of the Market Crossing procedures.

execute transactions.[37] To place a customer or proprietary order on the CFFE, an Authorized Trader must telephone and talk with a Terminal Operator. Trades can only be executed by the affirmative action of a Terminal Operator, who will interact extensively with the Authorized Trader especially during the Exclusive Time and Clearing Time work-up processes set forth in Cantor's "Algorithm" Case Study.

CFFE Rule 303 regarding Execution of Orders conveniently leaves out references to the role of Terminal Operators. It states that bids and offers to buy or sell a contract are "matched and executed electronically through the Cantor System."[38] However, Terminal Operators are an integral part of the "Cantor System." They receive, enter and execute all orders placed by Authorized Traders using securities industry voice brokerage techniques, and it is possible in nearly all cases to substitute the term "Terminal Operator" for "Cantor System" in Rule 303.

The Applicants are silent on the degree to which the Terminal Operators may communicate and interact with one another in performing their functions, not to mention with employees of other Cantor affiliates who may be present in the "pit". We have reason to believe that the Terminal Operators will engage in voice negotiations among themselves in the same manner as Cantor's cash brokers do today. They will certainly be operating in a trading room environment that would foster such interaction. Further, we anticipate that Terminal Operators will have a high degree of interaction with other persons through constant telephone communication, dispensing market information and trading advice. CFFE may not obligate them to provide these customer services, but CFFE does not expressly restrict them from doing so. Common sense indicates that they will.

3. Order Flow and Audit Trail

A customer who wishes to trade on the CFFE would call an Authorized Trader of the FCM carrying its account. An Authorized Trader must prepare a written record of each customer order he receives on an order ticket, including the date and time that he receives the order.[39] The Authorized Trader would then telephone a Terminal Operator to place the order. The Authorized Trader must also record the time when it "transmits" an order to the Terminal Operator.[40] However, if the order is rejected because of its inferiority (as described below), it is unclear whether the CFFE Rules would deem it "transmitted", and therefore it is unclear whether the Authorized Trader must keep a record

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[37] See, CFFE Marketing Materials, "CFFE, The interactive Marketplace - - Where Futures Meets Cash," p. 3; see also, Letter from Mike Uretsky and Bruce Weber of New York University to the Commission (April 6, 1998) (the "Uretsky-Weber Comment Letter") ("The proposed CFFE market will use a similar system to the Cantor trading system for the cash treasury market.").

[38] CFFE Draft By-laws, Rule 303.

[39] CFFE Draft By-laws, Rule 316(b).

[40] Id.

showing the time he made his oral request. The Applicants do not propose any synchronization of Authorized Traders' time stamping clocks, so the timing data could be inconsistent and provide an inaccurate indication of the sequence in which orders are transmitted to the CFFE.

An Authorized Trader may also place orders with a Terminal Operator for the proprietary account of the Clearing Member or Screen-Based Trader he represents. There is no requirement for Authorized Traders to keep a record of when a proprietary order is given to a Terminal Operator.[41] This means that the CFFE has absolutely no time records of when proprietary orders are transmitted to or received by a Terminal Operator. It is inconceivable that the CFFE could construct an accurate audit trail without these records, which the CFTC has deemed critical for other contract markets in order to detect "trading ahead" violations.

When a Terminal Operator receives a Customer or proprietary order, he will inform the Authorized Trader whether his bid or offer is eligible for entry into the Cantor System based on the trading priorities discussed in more detail below. If an Authorized Trader calls a Terminal Operator with a bid or offer that is not equal or superior to the prevailing price, the Terminal Operator will inform the Authorized Trader, orally, that the order is inferior, essentially rejecting the order.[42]

If the bid or offer is eligible, the Terminal Operator will post it on the Cantor System, where the order will rest until one of the following three things happen: (i) the bid or offer is canceled by a bid or offer at a more favorable price (it is unclear whether the Terminal Operator will inform an Authorized Trader when his order has been canceled), (ii) another Authorized Trader calls a Terminal Operator with an affirmative request to hit the bid or lift the offer (and that request is acted upon by the Terminal Operator), or (iii) the Authorized Trader who entered the bid identifies a corresponding offer on the system and calls a Terminal Operator to request the Terminal Operator to execute the trade. Execution requires a conversation with the Terminal Operator and action by the Terminal Operator based on the request.

Terminal Operators are not required to prepare any written record of the orders they receive, nor are they required to capture any time stamps of when they receive orders, when they reject orders based on inferior price, or when they receive instructions from an Authorized Trader to cancel, replace or modify an order.[43] In addition, the Terminal Operators have no record keeping requirements for proprietary trading of Authorized Traders (or record keeping requirements relating to EFP's that may be entered into by cash traders). At some unidentified time, when the Terminal Operator gets around

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[41] CFFE Rule 316(b), by its express terms, applies to orders that a Clearing Member or Screen Based Trader receives "from a customer." Id.

[42] Draft Responses, p. 19 at Question 45.

[43] See, CFFE Draft By-laws, Rule 303. It is also unclear what "transmitted" means in this context, because all orders must be given orally. Id.

to inputting the order, the computer system will reflect that time of input. The time lag that could occur between the trader's phone call and entry on the system is undefined and unconstrained, and absolutely no audit trail time records exist for the critical voice broker activities of the Terminal Operators.

According to the CFFE materials, at least one on-site supervisor will be present for every ten Terminal Operators ("Supervisor").[44] Each Supervisor will be registered with the Commission as a floor broker. No other information is given regarding the duties, responsibilities or disciplinary authority, if any, of Supervisors, or to whom they will report or in what manner they will be compensated. We presume, however, that the Supervisors will be CFFE employees who will not be executing orders. If that is true, the theory for the Supervisor's registration is unclear at best.

4. Replication of Exclusionary Cash Market Work-Up Practices: Exclusive Time and Clearing Time Trading Sessions

The marketing materials published to promote the CFFE state that the CFFE will bring the benefits of traditional "negotiated" trading to an electronic arena.[45] Based on our understanding and experience with the workings of the cash market for government securities, execution systems in those markets are generally built to accommodate large block trades between major dealers. The CFFE's trading standards seek to accommodate large block orders for futures by replicating cash market "work-up" conventions through "Exclusive Time" and "Clearing Time" trading sessions.

In a cash market work-up, participants in a trade have the right to continue to deal with each other exclusively to execute larger or additional trades at the same price until one person "drops out" of the transaction. Generally, the right to participate in a work-up is given to the first customer to place an order at the price that betters the market.[46] The market is tied up by two participants during the "work up period", and other traders do not have the opportunity to participate as they would in an open outcry pit. During the work-up period other participants in the system get no information about the trading that is occurring, for example, the size of the order the trading parties are seeking to fill. They only receive information about completed transactions some time after they occur. Display of completed transactions during the cash market work-up operates as a marketing mechanism for

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[44] Id., p. 3 at Question 10.

[45] CFFE Marketing Materials, "CFFE, The Interactive Marketplace - - Where Futures Meets Cash," p. 2.

[46] Although brokers should be expected to give the first customer in line the ability to participate, there is the potential for favoritism to occur. For example, a broker may give priority to a preferred customer or to a customer that has the largest order. CFFE's audit trail will not detect such misconduct, because it does not require Terminal Operators to timestamp orders when they are received. This potential for abuse is further magnified by the fact that some large-volume Authorized Traders on the floor of the NYCE may receive dedicated phone lines to specially assigned Terminal Operators. The decision of whether to provide these open lines will be based on the such trader's volume and the cost of installation. Draft Responses, p. 15 at Question 34.

the voice brokers. While these transactions are being executed and displayed on view-only screens, customers who wish to participate telephone their brokers and stay on an open line with their broker until the work-up is complete. When the work-up is complete, the broker states whether the buyer or seller "wants more." It is evident that by mirroring the cash market structure, Cantor wishes to transfer these closed and exclusionary block trading practices to the futures market.

Cantor's "Algorithm" Case Study describes how the Exclusive Time and Clearing Time procedures will operate.[47] In each case, the procedures grant certain Authorized Traders the exclusive right to trade, with all other traders frozen out of the market. In each case, an Authorized Trader is rewarded with exclusive dealing status if he places a bid or offer that is more favorable than the prevailing bids or offers and his bid or offer is entered by a Terminal Operator into the Cantor System first ahead of other bids and offers at the same price. Such bids and offers are called the "First Best Bid" or the "First Best Offer." Other bids and offers will be entered into the Cantor System only if they are equal in price to the First Best Bid or the First Best Offer and they will be given priority over later bids or offers based on their time of entry. If a requested bid or offer is inferior in price to the First Best Bid or the First Best Offer it will not be entered into the system. If a requested bid or offer has a more favorable price than the existing First Best Bid or First Best Offer, it will be entered onto the Cantor System and become the new First Best Bid or Offer, trumping and canceling the pre-existing First Best Bid or Offer (and any other inferior bids or offers on the system). With some major exceptions, discussed below, this system allows for entry of bids and offers at the best prevailing price only, with priority based on the time of entry.

The CFFE trade execution method incorporates the concepts of "Execution Time" and "Exclusive Time." "Execution Time" is defined as the period of time during which the Cantor System screen flashes the execution of a trade.[48] "Exclusive Time" is the period of time when participants in a trade have the exclusive right to continue to trade with each other, or (if one participant drops out) when a remaining trade participant has the exclusive right to continue to trade with other Authorized Traders who wish to join in at the prevailing price.

For example, if an Authorized Trader (Trader A) sees an offer on his view-only screen that he wishes to "lift" he will telephone a Terminal Operator and request lifting of the offer. If Trader A takes only part of the offer, Trader A's rights with respect to that offer will end when his trade is executed. However, the offeror (Trader B) will have the exclusive right for some period of time to continue to offer more to other Authorized Traders who have entered bids at Trader A's price . If there are

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[47] "The "Algorithm" - Case Study," accompanying the Applicants' November 5, 1997, submission (the "Algorithm Case Study"). The "Algorithm" is not, as the name implies, a matching algorithm applied by the electronic system.

[48] Id., p. 1. There is no indication of how long this time period is, and it may not be the time the execution actually occurs. The available materials do not explain when a trade is deemed to have occurred or whether that information is captured in an audit trail.

no other joining bids at Trader A's price, the remaining portion of Trader B's offer stays on the screen as the First Best Offer until it is either hit by an Authorized Trader or canceled by a superior offer.

If Trader A decides to lift all of Trader B's offer, Trader A will then have the exclusive right to trade with Trader B if Trader B wants to sell more.[49] If Trader A wants to buy more, Trader B also will have the exclusive right to continue to sell more to Trader A. This exclusive dealing will continue until either Trader A or Trader B no longer wishes to trade and "drops out". If Trader B does not continue to trade, Trader A will have the exclusive right to take offers from other Authorized Traders at Trader B's price.

During Exclusive Time, no new superior bids or offers can be entered onto the Cantor System. Trading can only be done at the "prevailing price." Trader C cannot break up the exclusive dealing between Trader A and Trader B by entering an offer at a price better than Trader B's price. Trader C will have to wait until Trader A and Trader B are done trading with each other, and all joining offers at Trader B's price have been taken or rejected by Trader A. Trader A will not know of the existence of Trader C's offer until Exclusive Time is over. Therefore, no mechanism exists for open and competitive trading by Trader C during the Exclusive Time. Similarly, the market itself is suspended during this time and cannot respond to changing economic conditions.

The Cantor "Algorithm" Case Study also incorporates another exclusivity concept called "Clearing Time" for some contracts. This procedure gives the Authorized Trader who submitted the First Best Bid or First Best Offer the exclusive right for a limited time ("Clearing Time") to buy or sell, as applicable, all or part of the offers or bids already posted on the Cantor System. The justification for this is unclear, but the purpose appears to be to facilitate the filling of large orders by one participant. It is unclear how Clearing Time and Exclusive Time operate together. The case study states that the existence of and duration of Clearing Time will vary from contract to contract, but does not specify how. Like so many other aspects of the Application, Clearing Time warrants further explanation.[50]

The CFFE's trading prioritization is extremely complicated to understand and even harder to describe on paper. The trading process becomes even more confusing when one imagines the boundless chain of Exclusive Time or Clearing Time sessions that could occur consecutively. As

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[49] The "Algorithm" Case Study explains that Trader A may "obtain" exclusive rights to trade during the time his order is flashing on the Cantor view only screen, but it is not explained how these rights will be obtained. It seems the Terminal Operator must have some role in granting these rights. Id. The Uretsky-Weber Comment Letter, does not clarify this confusion.

[50] The Uretsky-Weber Comment Letter makes "Clearing Time" sound like a right of first refusal that grants to the Authorized Trader that places the first best bid or offer the exclusive right to respond to the contra offer once it arrives. See, Id. at p. 9. But that description begs the question of how long the Authorized Trader has its "exclusive" right. How long, in other words, are open and competitive trading practices suspended?

long as there is no break in this chain, no superior competitive bids or offers can be entered. This format is the antithesis of the open and competition trading that the Commission's rules require and that facilitates price discovery in our markets.

Has the Commission made its own "case study" of how the system operates by viewing the Cantor System in a working environment? Has the Commission examined Cantor's current cash market trading system and observed the role of the voice brokers who will become Terminal Operators in the CFFE context? We believe an examination of Cantor's cash market operations will provide a good illustration of how the CFFE is intended to operate. We have serious questions whether this method conforms to open and competitive trading requirements and urge the Commission to carefully study Cantor's trading room operations and practices.

5. Market Crossing Sessions

The Applicants propose another mechanism for accommodating large block trading. Specifically, CFFE will allow crossing of orders during Market Crossing sessions.[51] For Treasury futures, the Market Crossing sessions will occur at times specified by the Committee on U.S. Treasury Securities.[52] We do not know if the CFFE has any policies or guidelines on the Committee's discretion on establishing Market Crossing Sessions. A person wishing to participate in a Market Crossing must place a bid or offer with a Terminal Operator at least one minute prior to the Market Crossing session.[53] It is unclear whether there are any limits on how far in advance a person may place a Market Crossing order or whether a person may place such an order even if no Market Crossing session has been scheduled at the time. The bid or offer cannot specify a price reference, and cannot be withdrawn during the one minute period prior to the crossing session.[54] The orders are entered into the Cantor System but are not posted over the screens.[55] Orders are matched during the crossing session at the price set for the particular Market Crossing.[56] Orders are matched on a time priority basis based on when they are entered into the Cantor System, and not when they are received by the Terminal Operators.[57]

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[51] Draft By-laws, Rule 303-A.

[52] CFFE Draft Treasury Futures Rules, Rule 833.

[53] Draft By-laws, Rule 303-A.

[54] Id.

[55] Id.

[56] Id.

[57] Id.

Little is known about how the trade match price will be determined for each Market Crossing session or the degree of latitude that is allowed for setting the price away from the market. The CFFE rules provide that the Market Crossing price will be determined "in accordance with the principles set forth in Rule 314," which is the rule for setting the settlement price for each contract.[58] Under that rule, the settlement price is established at either (1) the median price at which the last $25 Million aggregate amount of the contract traded that day or (2) if the computation "proves impractical," at the price set "in the reasonable determination of the Futures Committee, taking into account the prevailing differences between such Contract and the nearest active Contract month of the respective Contract and such other market information known to the Futures Committee."[59] Will these requirements be followed in exactly the same way for determining Market Crossing prices as for determining settlement prices? Under what circumstances may the Futures Committee disregard the median price computation and where to set the Market Crossing price? Is it possible for market participants to improperly influence the computation of the median price through trading prior to a Market Crossing session?

6. EFPs as a Potential Mechanism for Block Trading Away From the Contract Market

It is our understanding, based on reports of CFFE trade marketing calls, that CFFE is being promoted as a facility that will accommodate negotiated block trading in futures contracts at prices away from the prevailing market. Yet, in the Application materials, the Applicants provide no clear indication of their plans to allow or disallow this type of block trading. We are concerned that the Applicants may intend to accomplish off-exchange block trading indirectly under the guise of EFP transactions.[60] Although the Applicants provide very little information regarding EFP transactions, we know of two features which raise this concern.

First, the CFFE has no clear standards of what constitutes a bona fide EFP[61] or the records that must be kept to demonstrate compliance with the standards. Without adequate standards or record keeping requirements, the CFFE (through the NYCE) will not be able to conduct appropriate surveillance of EFP transactions to confirm that they are entered for legitimate purposes and not as a sham for trading outright futures contracts illegally off an exchange.

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[58] Id.

[59] Draft By-laws, Rule 314.

[60] The Market Crossing procedures also raise this potential concern.

[61] The CFFE Rules offer the confusing definition of an EFP as "any transaction entered into in accordance with the Rule 305 of CFFE, a component of which is not executed on the CFFE and a component or all of which involves a Contract." Draft By-laws, Rule 19.

Second, it is clear from CFFE's marketing materials that Terminal Operators can accept orders for EFP transactions, and not just reports of completed EFP transactions.[62] What is not known, however, is what role the CFFE, Cantor or the Terminal Operators will have in executing those orders. Will the CFFE provide an execution facility for EFPs? In that regard, will the Terminal Operators help solicit counterparty interest for an EFP order? Will they act as intermediaries in the private negotiations between two potential counterparties on the terms of the futures and cash components of the transaction? Or is it the intention that Cantor would provide an execution facility for EFPs and that the Terminal Operators, accordingly, would pass off all EFP orders they receive to Cantor?

In the final analysis, we do not know for certain whether CFFE plans to accommodate privately negotiated block trading of outright futures through the EFP mechanism because the Applicants have provided virtually no information on EFPs for us to carefully evaluate. But it is precisely this lack of information that makes us question the Applicants' true motives. The Commission should carefully examine the CFFE's proposed EFP rules and procedures to verify whether the Applicants' are seeking to circumvent the federal proscriptions against outright block trading of futures away from exchange markets.

C. Customer Protection Concerns: Potential for Favoritism and Abuse

Despite performing the critical role of trade execution, Terminal Operators will not be held to proper standards of conduct and will lack accountability under the CEA. The Applicants maintain that Terminal Operators will not be registered under the CEA, because they will only be inputting trades in a clerical capacity. The Applicants stated in their draft response to the Commission's questions dated January 6, 1998, that Terminal Operators would not be holding a book or deck of orders, will act only on instructions, will have no discretion over accounts, and will not "solicit" orders because they will be acting in a "clerical" capacity.[63] Yet, Terminal Operators will perform many roles traditionally performed by registered floor brokers, FCMs and introducing brokers on an exchange. Further, they will be registered with the NASD, so it appears they may be simultaneously performing a non-clerical role in the cash market.

Terminal Operators take phone calls, reject orders, input orders and execute orders on behalf of customers. They will interact with Authorized Traders for single order entry and during the intense work-up sessions which Exclusive Time and Clearing Time facilitate and may give market color or other opinions. Although the CFFE's rules specifically exempt Terminal Operators from any requirement to provide information in handling phone orders, nothing in the materials suggests that a Terminal Operator would be prohibited from giving information if asked, and there are no

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[62] CFFE Marketing Materials, p.3 ("For ease of execution, the CFFE will provide, for the first time, the ability to execute cash and futures trades with one phone call.").

[63] Draft Responses, p. 3 at Question 10.

provisions governing how this information would be provided, for instance, whether Terminal Operators can treat some Authorized Traders differently than others. Nothing suggests that a Terminal Operator would be prohibited from telling an Authorized Trader about the existence of "Clearing Time" or "Exclusive Time", or from quoting the market, and Terminal Operators are clearly permitted to inform a trader that his bid or offer is inferior. Although the CFFE Rules contain a provision prohibiting the disclosure of "material non-public" information, it is hard to see how a Terminal Operator could avoid using that information if he were also soliciting business or trading for Cantor's (his employer's) account in the cash market, as the CFFE marketing materials and NASD registration suggest is possible.[64] It seems implausible that the Terminal Operator could perform his functions without providing extensive information and advice.

The possibility that Terminal Operators will release information or give advice is even more likely in some cases, because the CFFE does not require Authorized Traders to install or use a CFFE view-only terminal.[65] It would be impossible for Authorized Traders without screens to execute trades in a vacuum without requesting some information from the Terminal Operator.

The conflict of interest raised by Terminal Operators' lack of independence from Cantor will exacerbate the potential for abuse of the system. Terminal Operators will be affiliated with Cantor through a joint employment arrangement between Cantor Fitzgerald Securities and the CFFE. They may be encouraged by Cantor to release information in an asymmetrical fashion as Cantor allegedly has encouraged in the past in the cash market.[66] Terminal Operators also may be more inclined to accommodate requests from Authorized Traders who are employed by Cantor or who are significant customers of Cantor, and may be tacitly expected to facilitate profits through releasing non-public information or through pre-arranging trades for Cantor and its customers on the system. In addition, they may personally profit from the release of information or use of information in their cash market activities through commissions or compensation arrangements.

All of the foregoing practices are made more likely by the fact that the NYCE, which is in charge of surveillance, has no role in selecting Terminal Operators, and there are no standards governing their qualifications. The Applicants state only that the NYCE's compliance personnel will be able to remove Terminal Operators for "compliance-related reasons", but cite no examples of what these reasons would be, or how the NYCE would have jurisdiction over them, and propose no meaningful trading standards, execution procedures or compliance rules for them. Presumably, the CFFE board would have the right to review any appeals in disciplinary proceedings brought by the NYCE's two

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[64] CFFE Marketing Materials, p. 2. ("Cash market participants will have the added benefit of being able to execute cash and futures with one phone call").

[65] Draft Responses, p. 16 at Question 35.

[66] See, Jaffe at p. 78.

compliance personnel. But again, the CFFE board is controlled by Cantor which employs the Terminal Operators.

Terminal Operators are the crucial players in the CFFE trading system. The Terminal Operators and the CFFE should be subject to trade practice surveillance through proper registration as floor brokers or associated persons for performing trade execution functions just like they would be on electronic systems approved by the Commission.

Previous electronic trading systems approved by the Commission, including the CBOT's Project A® trading system, adopted an order entry process consistent with the existing regulatory structure. Customer orders are only handled by entities and individuals who maintain appropriate registrations. Customer orders are input into the system by the registrant or an agent/employee of the registrant, who in turn is registered by the exchange and subject to its trading standards. All registrants in the customer order chain have fiduciary and legal incentives to act in the best interest of the customer. Each is subject to Commission and exchange disciplinary jurisdiction and binding arbitration provisions under established futures law.

The CFFE model simply ignores this established regulatory structure. The Commission's and the industry's concerns for customer protection are supposed to be mollified by the presence of an electronic trading system. But as discussed above, the Cantor System implements Cantor's traditional voice broker system that is connected by a computerized bulletin board network. In fact, Cantor itself calls it a "screen based brokerage system" where business is transacted over "broker-facilitated trading screens."[67] The brokers in those descriptions are the Terminal Operators. Immunizing them from CFTC scrutiny and exchange oversight is completely antithetical to the customer protection features of the Commodity Exchange Act.

II. Issues Regarding Cantor's Fitness to Control a Federally-Licensed Exchange

Published reports and settled proceedings concerning past practices of Cantor Fitzgerald & Co. and its affiliates create serious doubts whether Cantor would satisfy applicable fitness standards for controlling and operating a federally designated contract market. In May of 1994, the Commission filed charges against Cantor Fitzgerald & Co. for assisting Vancorp Financial Services in committing fraud in managing investment money for International Participation Corp., primarily through trading Treasury Bonds and over-the-counter options on Treasuries.[68] A little more than a year ago, Cantor Fitzgerald & Co. paid a $500,000 fine, agreed to a cease and desist order and accepted various undertakings in a CFTC settlement order finding that "Cantor aided and abetted fraud and

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[67] See, Cantor's Website, http://www.cantor.com.

[68] See, CFTC News Release No. 3766-94 (May 27, 1994) (announcing the filing of CFTC Docket # 94-14).

registration violations."[69] In announcing that settlement, Enforcement Director Geoffrey Aronow stated:

> "This settlement sends an important message to firms handling funds on behalf of commodity pools. The diligence of these firms is the customer's first line of defense against improper use of funds or unauthorized or improper trading. Firms cannot ignore warning signals, let alone explicit information, of improper conduct."[70]

It has been reported that, in a related civil suit brought by Vancorp Financial Services against Cantor Fitzgerald & Co., Vancorp also alleged that Cantor acted not as a broker, but as a dealer in conducting transactions with Vancorp, without disclosing this to Vancorp.[71]

The Securities and Exchange Commission also has found Cantor Fitzgerald & Co. to have violated regulatory requirements. On March 17, 1994, the SEC simultaneously filed and settled a complaint against Cantor Fitzgerald for having failed to record certain customer orders, trades and execution times in connection with the non-competitive auction of certain U.S. Treasury Securities.[72] For that misconduct, Cantor Fitzgerald was ordered to cease and desist from violations of federal securities laws and pay disgorgement of $90,000 and a civil money penalty of $100,000.[73]

In addition to the foregoing suits, it has been reported that former employees of Cantor Fitzgerald Securities have disclosed that, for a time, traders in the Cantor Investment Strategies Group (now called the "Global Trading Strategies Group"), were given an unfair trading advantage through access to material non-public information on the internal screens that the wholesale brokers used in the brokerage rooms of Cantor Fitzgerald Securities (the entity that will provide Terminal Operators to the CFFE).[74] Those screens show, by account number, which customers have been the buyers and

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[69] "CFTC Accepts Settlement of Cantor Fitzgerald & Co. Charged with Aiding and Abetting Fraud and Registration Violation of Federal Commodity Law," CFTC News Release No. 3987-97 (Jan. 28, 1997).

[70] Id.

[71] Thomas Jaffe, "Between the Wall and the Wallpaper," Forbes, October 20,1997, p.82, attached as Exhibit D to this letter.

[72] "Cease and Desist Order Entered Against Cantor Fitzgerald & Co.," SEC News Digest, 94-50 (March 17, 1994).

[73] Id.

[74] Jaffe, p. 78.

sellers for the last few trades in a given security. The customers reportedly did not have this information.[75]

A half-dozen former employees of Cantor's Global Trading Strategies Group also have alleged that over the years, the firm frequently traded ahead of its customers.[76] Cantor Fitzgerald & Co. is also alleged to have covertly traded in U.S. Government Securities for itself against customers through First Nevada Associates, a private partnership formed by Howard Lutnick and affiliated with Cantor, by carrying positions and processing trades through the entity.[77]

Given Cantor's controlling and highly sensitive role in CFFE, these agency actions and reported allegations must raise concerns for the Commission that should at a minimum be thoroughly investigated. On its face, however, the Cantor-CFTC settlement would appear to preclude approval of the CFFE application. Cantor will control CFFE's board of directors and exclusively operate its trading system. Yet Cantor's CFTC settlement would render it ineligible to serve on the board of any self-regulatory organization under CFTC Rule 1.63 (b)(2) since it has entered into a settlement agreement in the last three years in which the findings constituted a disciplinary offense. If Cantor cannot lawfully serve on the board of an SRO, it should not be allowed to appoint 8 of 13 members of an SRO board as the CFFE application envisions. That is particularly true here, where the CFTC disciplinary offense is not the only agency finding or allegation that has been made against Cantor. Simply put, on this record, as CFTC Rule 1.63 (b)(2) underscores, approving the Cantor application, with its inherent violations of federal fitness standards, would be contrary to requirements applicable to any board of trade seeking designation as a contract market (CEA §5(6)) as well as the public interest (CEA §5(7)).[78] On this basis alone, the Commission has compelling grounds to deny CFFE's application.

III. Analysis of CFFE Under CEA and Commission Requirements

In addition to the failure to comply with statutory requirements in the areas of noncompetitive trading and fitness standards, the Application is marred by a host of other legal deficiencies. These deficiencies would divest the Commission of its oversight role and deprive CFFE customers of appropriate recourse if the abuses invited by the CFFE's structure do occur.

A. Trading Standards

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[75] Id., p. 78.

[76] Id., p. 82.

[77] Id., p. 78-82.

[78] See also, CEA §5a(a) (16).

1. CFTC Rule 1.38: Non-Competitive Block Trading

As discussed at length in Part I. CFFE is designed to replicate cash market execution systems that accommodate large block trades between dealers. While those trading conventions may be acceptable for major dealers trading among themselves, customers generally seek more transparency and are best served by avoiding non-competitive trading. The closed and non-competitive practices embodied in the CFFE model are the subject of the Commission's separate, parallel Concept Release which seeks public comment on arguably momentous changes to the manner in which trading is conducted on U.S. contract markets. CFFE cannot be afforded approval to engage in block trading unless and until final rules are adopted by the Commission to authorize non-competitive trading at the expense of price discovery and effective hedging in exchange markets.[79]

CFTC Rule 1.38 states 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 the posting of bids and offers by other equally open and competitive methods, in the trading pit or ring or similar place provided by the contract market..." The Exclusive Time and Clearing Time concepts violate that legal requirement by ensuring unequal access and execution opportunities, preventing the timely entry of the most competitive bids/offers and trading at the best price, and limiting the dissemination of relevant market information. The Market Crossing sessions may also violate that legal requirement, but more information is required to make that determination.

When these basic defining features of Cantor's system are combined with the Terminal Operator's lack of independence from Cantor and their lack of CFTC registration, the potential for inequitable information flow, the lack of trading standards and grievance procedures, and the absence of a meaningful surveillance and audit trail framework, all discussed below, CFFE must be viewed as a market that supports noncompetitive trading and other abusive conduct.

2. CFTC Part 155 Rules

Although the CFFE is set up as an unorthodox trading platform on which exchange personnel will execute orders, the Applicants have stated that they will not be submitting rules regarding trading standards set forth in Part 155 of the CEA regulations (with the limited exception of CFFE Draft Rule 311 relating to prearranged trades). They maintain that the "Cantor System is the pit" when really the CFFE trading platform is a hybrid between voice brokerage and electronic trading. The CFFE will not automatically accept or match the bids and offers entered into the system. As mentioned above, trades can only be executed through contacting a CFFE/Cantor employee who is a Terminal Operator responsible for accepting or posting a bid or offer on the system for an Authorized Trader. Since a significant amount of human interaction must occur before a trade is

[79] The Exchange would vehemently oppose such rules insofar as they would undermine the statutory purposes of market liquidity, price discovery and efficient hedging.

executed, the Terminal Operator role is analogous to a floor broker's within a pit. with Terminal Operators conducting the same types of activities that Cantor's voice brokers perform in the cash market and requiring the same degree of skill and judgment. Therefore, Terminal Operators should be registered.

In addition to CFTC registration. the CFFE structure warrants trading standards for and accountability of Terminal Operators, a framework for monitoring compliance with standards and a forum for recourse by customers, all of which appear to be totally lacking. For example, no restrictions appear to apply to Terminal Operators to prohibit them from trading or engaging in pre-arranged trades as they are interacting with Authorized Traders on the telephone. The Rule 311 prohibition on prearranged trades only applies to Clearing Members and Screen Based Traders. Since the Terminal Operators will be performing execution functions just like traditional floor brokers or executing FCMs, they should be held to the competitive trading requirements set out in CFFE Rule 311 as well as the Commission's other Part 155 Rules and Sections 4b and 4c of the CEA.

Competitive trading rules are also relevant for the activities of persons authorized to place orders directly with Terminal Operators, whether for their own account or for customers. We note that the original draft of the CFFE's rules dated November 5, 1997, did not contain any prohibition on prearranged trades. Now, CFFE Rule 311, set forth in the draft rules dated January 6, 1998, prohibits any "Screen Based Trader" or "Clearing Member" from making any purchase or sale that has been directly or indirectly prearranged. However, no information is presented to describe how the behavior of Screen Based Traders and Clearing Members will be monitored by NYCE surveillance to prevent prearranged trades, including computer systems to monitor these activities. Two Screen-Based Traders could privately negotiate a trade and then call Terminal Operators, who are not accountable under the rule.

3. Inadequate Restrictions on Cantor's Trading Activities

We also have concerns about the adequacy of CFFE's restrictions relating to Cantor's potential trading activities on the CFFE, or in related markets, based upon confidential or market sensitive information Cantor obtains through its role on the CFFE. In question number 12 of the Commission's questions concerning the CFFE and NYBOC dated December 12, 1997, the Commission asked whether any trading arm affiliates or subsidiaries of the CFFE would be able to conduct trading on the CFFE, either directly or through an NYCE member. The CFFE's response fails to indicate whether such entities will be trading futures on the CFFE, only that such entities will not be trading "government securities" and that Cantor Fitzgerald & Co. will be a Clearing Member of the CFFE, subject to the same rights and obligations as other Clearing Members. It appears, therefore, that at least one Cantor affiliate will be trading futures and it may trade for its own account and engage in customer trading. The CFFE does not propose rules or exemptions relating to dual trading. Further, no audit trail or record keeping is proposed to monitor proprietary trading, as previously mentioned.

The CFFE has adopted the requirements set forth in §1.59 of the CEA regulations requiring exchanges to prohibit their employees from taking positions. However, Cantor Fitzgerald & Co. will be allowed to trade futures for its own or customer accounts through the CFFE. Section 1.59 does not specifically prohibit equity owners from taking positions. However, the CFFE structure violates the purpose and spirit of CFTC Rule 1.59 since Cantor Fitzgerald, L.P. owns (i) CFFE. LLC which will control and manage the exchange, (ii) Cantor Fitzgerald & Co. which will take positions on the CFFE, and (iii) Cantor Fitzgerald Securities which will provide critical exchange personnel. Furthermore, the CFFE's prohibition appears only to apply to futures contracts, and no mention is made about whether Terminal Operators could trade for their own or their employer's (Cantor's) account or others in related cash markets, and how they could be prevented from using or disclosing material, non-public information in that context. The CFFE marketing materials state, "that the cash market participant will have the added benefit of being able to execute cash and futures with one phone call."[80] So it appears that no exchange rules would prohibit CFFE Terminal Operators from taking positions on behalf of Cantor, their employer, in the cash market using material non-public information related to futures trading on the CFFE.

B. EFPs

The CEA permits EFP transactions to be executed off an exchange, even though they involve a futures component, so long as they occur "in accordance with board of trade rules" that have been approved by the Commission.[81] The Commission has long enforced the position that an EFP must be a bona fide commercial transaction and not a sham for engaging in illegal trading conduct, such as trading futures off-exchange.[82] For the reasons explained above in I.B.6, we are concerned that the CFFE's requirements for EFPs (or, more precisely, the lack thereof) could allow non-competitive block trading of futures to occur under the guise of EFP transactions, in contravention of that fundamental legal requirement. The Applicants have also failed to demonstrate that the CFFE will comply with the recordkeeping requirements of CFTC Rule 1.35(a), 1.35(e) and 1.38 pertaining to EFP transactions.

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[80] CFFE Marketing Materials.

[81] CEA §4c.

[82] See, Concept Release on Regulation of Noncompetitive Transactions Executed or Subject to the Rules of a Contract Market, 63 Fed. Reg. 3708 (Jan. 1998). In 1985, the Division of Trading and Markets stated that the "EFP exemption was not designed to create an avenue for traders to use EFP transactions to accomplish what they could not otherwise legitimately do, that is, wash trades, accommodation trades, fictitious sales or illegal, off-exchange transactions." Report of the Division of Trading and Markets: Volume Investors Corporation, p. 50 n. 54 (July 1985).

The CFTC has raised questions about whether it should modify its approach to regulation of EFP transactions in a separate CFTC Concept Release.[83] In our comment letter on that release,[84] the Exchange generally opposes any additional regulation of EFP transactions, although we do offer one area where we believe the Commission should adopt an additional safeguard. Specifically, in our view, the Commission should not permit an exchange to adopt rules allowing EFP transactions involving a futures contract that clones an active, established futures contract offered by another exchange unless and until the clone contract becomes established as a successful and viable contract on its own merits. Please refer to our comment letter on the Concept Release for a more complete discussion of this position and the market fragmentation concerns underlying that position.

C. Surveillance and Audit Trail

1. CFFE Will Undermine Already Strapped NYCE Surveillance Capacity

The CFFE's potential problems will be exacerbated by the structural flaws cited by the Commission in the NYCE surveillance program. In the words of Cantor, "The [NYCE] has agreed to perform the regulatory responsibilities with respect to CFFE in the manner and to the extent it performs its own self-regulatory responsibilities."[85] In the Commission's Rule Enforcement Review of the Market Surveillance Program at the NYCE, dated February 24, 1998, the Commission found that "the Market Surveillance Department ("MSD") at NYCE has insufficient staffing levels to monitor effectively the number of markets traded on the [NYCE], and to conduct other routine surveillance activities, including the review of selected EFPs..."[86] NYCE has seen over a 200% increase in the number of markets it has to monitor since 1993. Notwithstanding the growth in the number of contracts traded over the past several years, the MSD staff has not grown. In fact it has shrunk, to only two full-time personnel. In addition, the Commission determined that the NYCE does not give adequate consideration to whether requested speculative limit exemptions are too large relative to the liquidity available in a market. In several instances, updated exemption applications were not obtained by the NYCE in a timely manner. The NYCE does not produce automated reports that compare exemption levels to existing positions. The NYCE does not maintain any market surveillance logs that reflect the progress of MSD inquiries, the status of hedge exemption applications or the level of exemptions approved. The Commission also found instances where inquiries involving possible speculative limit violations and reporting problems should have resulted

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[83] See.

[84] Letter from Thomas R. Donovan, President & CEO, Chicago Board of Trade, to Ms. Jean Webb, Secretary, Commodity Futures Trading Commission (April 27, 1998) (regarding the Commission's separate concept release on regulation of noncompetitive transactions).

[85] Draft Responses, p. 10 at Question 13.

[86] Rule Enforcement Review of the Market Surveillance Program at the New York Cotton Exchange, Commodities Futures Trading Commission, Division of Trading and Markets, p. 28 (February 24, 1998).

in warning letters but did not.[87] The Commission was especially critical of the NYCE's almost non-existent program for monitoring EFP transactions. In light of these problems, we question whether CFFE's enforcement program, administered by the NYCE, will satisfy the requirements of Commission Regulation 1.51.

2. No Specific Surveillance or Audit Trail Procedures Proposed

Quite apart from whether the NYCE has the resources available to perform proper surveillance, no concrete surveillance procedures have been proposed and the NYCE has no experience in monitoring a broker facilitated screen-based trading system. According to CEA §5a(b)(17)(B), the Commission is supposed to review all audit trail procedures before granting a contract market designation. These procedures are supposed to include: physical observation of trading areas; audit trail and record keeping systems able to capture essential data on the terms; participants and sequence of transactions (including relevant data on unmatched trades and out-trades); systems capable of reviewing data on trades effectively on a regular basis to detect violations committed in making trades and executing customer orders subject to the rules of such contract market (including all types of violations attributable to dual trading); the use of information gathered through the system on a consistent basis to bring appropriate disciplinary actions against violators; commitment of resources to such system necessary for it to be effective in detecting and deterring violations, including adequate staff to develop and prosecute disciplinary actions; the assessment of meaningful penalties against violators; and the referral of appropriate cases to the Commission. Nothing in the record suggests that the Commission has reviewed the CFFE's proposed monitoring procedures against all of the audit trail requirements set forth in regulation §5a(b)(17)(B).

That review must address a series of difficult questions. What types of computerized audit trail programs does the NYCE plan to use to monitor for trading abuses? Are the two surveillance personnel employed by the NYCE experienced in monitoring computerized systems and using these programs? What happens when both compliance employees are sick or otherwise absent? How many programmers does NYCE have to analyze data produced by monitoring programs? In connection with the approval of Project A's audit trail, the CBOT stated our view, and we continue to hold this view today, that electronic trading systems are not sound simply because they are electronic; they are sound if they can provide an exceptional audit trail.

Moreover, Congress and the Commission have focused considerable attention on exchange audit trails. CEA§ 5(8) requires the Commission to find that all contract markets for which a board of trade has been designated are in compliance with the statutory audit trail requirements before a new designation will be granted. Based on the available record, the CFFE's ability to comply with the audit trail standards is in serious doubt.

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[87] Id., pp. 28-30.

CFFE's trade execution system involves a significant amount of human interaction before a trade is executed. Yet Terminal Operators do not time stamp orders, as they would in an open outcry environment. Nothing indicates that CFFE has defined when an execution actually occurs on the system. If two Terminal Operators were to orally agree to a trade for their customers, would that agreement constitute an execution as it would on the trading floor? If so, CFFE has no apparent basis to time that execution. Of course, CFFE could time when the trade is reported on the trading screen but that is not the execution time. Indeed, all futures exchanges could have perfect audit trails if the time of execution is the time the trade was submitted for clearing or reported as a match on clearing systems. That kind of after-the-fact accounting is not what Congress had in mind, we believe. CFFE also has not specified how it will prevent big customers from receiving priority treatment before orders are entered onto the system or how its audit trail will monitor for dual trading. These serious questions must be answered.

While the Supervisor appears to be designated for some compliance role, there is no description of this role. What entity will employ Supervisors -- the NYCE, Cantor or the CFFE -- and how will they be accountable? What are their qualifications? Will Supervisors have disciplinary authority? This is of special concern, because the CFFE "pit" will be located in a non-public environment, communications will take place over the telephone and no standards for Terminal Operators, Screen-Based Traders or Clearing Members have been adopted. It seems that the NYCE may really be relying on some branch of Cantor to perform its SRO functions. If so, how will Cantor be accountable? How can it be accountable given its own participation in the market? Will there be a third-party audit of Cantor's activities and does the Commission have jurisdiction over Cantor? Does the Commission plan to have its staff observe CFFE trading activities first hand just as the Commission monitors activities on the exchange trading floors today?

D. Risk Disclosure

In spite of all the risks posed by the CFFE, including the Terminal Operator's conflict of interest, the lack of registration, lack of trading standards on the CFFE, and the extremely limited grievance procedures, discussed in the following section, the Applicants have submitted a risk disclosure statement that is so vague and incomplete in describing the risks of trading on the CFFE that it is misleading.[88] For example, the statement does not highlight human error of Terminal Operators as a risk associated with using the CFFE; rather, it only contains a heading regarding the risk that the electronic system could fail. It does not mention the joint employment relationship of the Terminal Operator with Cantor or that Terminal Operators will not be registered under the CEA and Commission rules. It does not mention the possibility that Cantor entities will trade on the system for their own account using the jointly employed Terminal Operators or that Terminal Operators may conduct cash market activities. All of these facts would weigh heavily in most customers' decisions to trade on the CFFE.

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[88] See, CFFE Customer Information and Risk Disclosure Statement, submitted by the Applicants to the Commission (January 7, 1998).

Further, in describing the trade execution process, the disclosure statement does not clarify that superior competing bids are not eligible for entry into the system during Execution Time or Exclusive Time, but only that joining bids (at the same price) are allowed. It also does not give a description of how the concepts of Execution Time, Exclusive Time and Clearing Time will operate or that they will exclude all other bids or offers for an unlimited time. It does not define the terms "First Best Bid" or "First Best Offer". In addition to these omissions, it makes the seemingly inaccurate representation that, "where multiple bids or offers co-exist at the same "best" prices, the system will match them with a seller or buyer on a time priority basis based on the time they were entered into the system, until such seller or buyer has filled its order or there are no more bids or offers at such seller's or buyer's designated price." Which seller or buyer? This conflicts with other descriptions of the system that require an aggressor in each transaction and provide for exclusive time between two participants. Given these unexplained and contradictory statements, it would be easy for a customer to become confused and misled about the priority his order will receive on the system and what is necessary to execute a trade.

All of this vagueness and omission will make customer claims even more likely. However, the Risk Disclosure Statement only quotes the limitations of liability set forth in CFFE Rule 723 and Rule 724 disclaimers, which significantly limit when relief will be offered and the level of that relief. As discussed below, the application of these rules is open to interpretation. The Risk Disclosure Statement does not even mention that arbitration is available to the CFFE's customers, if indeed it is, or that their recourse is limited further because certain market participants are not registered under the CEA.

E. Customer Grievance Procedures

Section 5(a)(11) of the CEA requires contract markets to provide fair and equitable procedures through arbitration or otherwise for the settlement of customers' claims and grievances against any member or employee. However, Cantor implies that it plans to give the SEC jurisdiction over CFFE disputes through registering the Terminal Operators as Government Securities Representatives with the NASD. The Commission should strongly object to this limited registration for individuals executing trades, because the NASD provides an insufficient venue for arbitration of futures trading practices. The SEC and the NASD do not have jurisdiction over futures trading, and the Commission should not, and legally cannot, allow a designated contract market to choose its own regulatory forum.

In spite of the obvious principal/agent arrangement with Terminal Operators, potential for asymmetric information flow and favoritism, and active participation in the execution of futures trades, Cantor Fitzgerald Securities does not propose registering as an FCM or registering the Terminal Operators as floor brokers under the CEA. The Commission therefore would not have jurisdiction over Cantor Fitzgerald Securities, the Terminal Operators or the CFFE for customer complaints for trading violations by Terminal Operators. Without that jurisdiction, the Commission can not be sure that fair grievance procedures will be observed.

CFFE Rule 600 states that controversies regarding transactions made on the CFFE involving persons under CFFE jurisdiction shall be determined under and governed by the Consolidated Rules of the NYCE. Over whom does the CFFE have jurisdiction? Authorized Traders only? How will the CFFE have jurisdiction over Cantor Fitzgerald Securities or Terminal Operators?

CFFE Rule 724 is meant to limit the CFFE's liability for services performed by Terminal Operators so that the CFFE will only be liable for the acts of Terminal Operators who negligently (i) cancel or fail to cancel orders resting in the Cantor System; (ii) deactivate a CFFE terminal; (iii) fail to deactivate a CFFE Terminal pursuant to instructions by a Clearing Member or Screen Based Trader, or (iv) issue passwords to unauthorized persons in violation of instructions by a Clearing Member or Screen Based Trader.[89] Liability for these activities is limited to $10,000 for any single claim, and $100,000 arising from the negligent actions or failures to act of all Terminal Operators for all claims on any single business day. CFFE Rule 724 does not address liability for a Terminal Operator's failure to enter or act upon an order. Further, the rule does not address claims involving willful or knowing behavior of Terminal Operators which would be more egregious. These types of violations seem to be covered by Rule 723 which contains a blanket disclaimer limiting the CFFE's liability for actions by employees, Cantor and its affiliates, unless there is a finding of willful and wanton misconduct.

The Applicants stated in response to the Commission's request for clarification, that they intend to limit the CFFE's liability where a Terminal Operator is negligent in entering an order.[90] However, it is unclear whether the Applicants mean to limit their liability entirely, or to $10,000 per violation. Although many electronic markets use disclaimers for system errors and malfunctions, these disclaimers are unprecedented when applied to human error in the order entry process.[91] If a no-fault disclaimer like Rule 723 was implemented at the CBOT, floor brokers in the CBOT's pits would have no liability for errors made negligently or with knowledge. Further, the CBOT would have no liability for failing to enforce trading standards as they apply to floor brokers unless it resulted in willful and wanton behavior.

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[89] Draft By-laws, Rule 724. We do not know what activating or failing to deactivate a terminal would do.

[90] Draft Responses, p. 25 at Question 70.

[91] For instance, the CBOT limits its liability for system malfunctions generally (CBOT Regulation 188.03, Exchange Liability) and specifically for Project A system failures (CBOT Regulation 9B.21, Project A Limitation of Liability). At the request of the Commission and consistent with the Exchange's previous GLOBEX system limitation of liability, the CBOT's August 19, 1993 proposal to adopt Regulation 9B.21 excluded from the limitation of liability claims against a member, clearing member, or other person acting as agent arising out of any act, incident or occurrence within their control. Additionally, on September 20, 1993, language expressly indicating the applicability of the CEA and its grievance procedures to electronic transactions was added. The language, incorporated at the insistence of the Commission, was intended to clarify that the CEA's grievance procedures and the liability of those within the order handling process could not be limited by rule of a contract market. CFFE Rule 724 mimics the GLOBEX Limitation of Liability. The important distinction, however, is that GLOBEX control center employees would not be integral to the order entry process.

Cantor also states in defense of Rule 724 that it is a condition for trading on the system. and will be disclosed in the risk disclosure statement.[92] What if a Terminal Operator knowingly fails to hit a bid or offer to favor one Authorized Trader over another? Will the risk disclosure statement clarify that there is no recourse for negligent or knowing failures by unregistered Terminal Operators to enter the orders of Authorized Traders? Is liability for this practice disclaimed entirely by the CFFE, or will damages for this type of abuse be limited to only $10,000? Will the arbitration described in Rule 600 take place under the CFTC's jurisdiction? How can these limitations be consistent with CEA §5(a)(11)?

The NYCE's rules have been revised so that the NYCE may hear arbitrations against Terminal Operators.[93] However, the change is not specific enough to indicate whether this provides a forum for customer arbitration or is limited to claims by Clearing Members and Screen Based Traders, and neither scenario is clearly contemplated. It also appears that customers will be denied the right to file reparations under the CEA Section 14 and the Commission's Part 12 rules against Cantor and/or Terminal Operators for misconduct because these reparations are only available against CEA registrants, and it appears that neither the CFFE, Cantor Fitzgerald Securities or the CFFE will be registered with the Commission. Therefore, even with a cause of action, customers may be further restrained in their ability to seek recourse through arbitration or reparations.

F. Non-Compliance with Diversity Standards

1. The CFFE Board

In 1993, the Commission adopted diversity requirements regarding the composition of the governing boards and major disciplinary committees of contract markets to implement the requirements of Sections 5a(a)(14) and (15) of the CEA. These requirements, which the Commission stringently applies to existing contract markets, are set out in CFTC Rule 1.64.

With respect to board composition, Rule 1.64(b) requires each contract market to maintain standards and procedures to ensure that:

- 20% or more of the regular voting members on the board, who must be knowledgeable about futures trading or financial regulation or otherwise capable of contributing to the board's deliberations, are <u>not</u>: members of the contract market, employees of the contract market, or officers of principals or employees of a member firm.

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[92] Draft Responses, p. 25 at Question 70.

[93] <u>See</u>, Amendments to the Consolidated rules of NYCE, submitted by the Applicants to the Commission (January 7, 1998).

- At least 10% of the regular voting members must represent farmers, producers, merchants or exporters of the principal commodities underlying the contracts offered by the contract market; and

- The board's membership includes a diversity of membership interests at the contract market.

The CFFE By-laws provide for a board composition of thirteen directors, five appointed by Cantor, five appointed by the NYCE, and three independent directors appointed by Cantor. While the composition appears on its face to comply with the Reg. §1.64 requirement that 20% of the Board must be composed of outside directors, these "independent" directors may not be truly independent from Cantor. The CFFE By-laws do not restrict Cantor from appointing its agents or its large customers as independent directors. In addition, without stating any justification, the Applicants have concluded that the 10% producer/merchant requirement does not apply to them.

2. Major CFFE Disciplinary Committees

Rule 1.64(c) requires markets to ensure that their major disciplinary committees (including hearing panels) include:

- At least one non-member of the contract market in disciplinary proceedings that involve a board member or member of a major disciplinary committee;

- At least one non-member of the contract market in disciplinary proceedings that involve allegations of manipulation or conduct that directly results in financial harm to a non-member of the contract market;

- A majority (greater than 50%) of persons who represent membership interests that are not the subject of the disciplinary proceeding; and

- Sufficiently diverse interests to ensure fairness and prevent favoritism in conducting the committees' or panels' responsibilities.

The By-laws delegate most regulatory and disciplinary functions to the NYCE committees. However, Section 26 of the CFFE's Draft By-laws designates the Committee on Recordkeeping as a standing disciplinary committee of the CFFE. According to the Applicants, the NYCE believes this is a more efficient approach, because a committee comprised of CFFE board members would be more "familiar" with the Cantor System and therefore be able to "summarily dispose" of certain record keeping violations.[94] If the NYCE is performing surveillance, will it not be familiar enough with the Cantor System to make decisions regarding record keeping violations? How will it be able

[94] Draft Responses, p. 9 at Question 10.

to perform its other surveillance duties without understanding the Cantor System? What is the justification for keeping the Committee on Recordkeeping a CFFE committee?

CFFE's draft proposed Rule 35(b) states that all major disciplinary committees must include at least one person (Exchange Non-Member) who does not have CFFE trading privileges or a membership in the NYCE, meaning that a Cantor affiliate without those privileges could serve in such a capacity. According to Rule 35(b), the CFFE Committee on Recordkeeping, mentioned above, could have Cantor appointees from the CFFE board of directors and one additional Cantor affiliate serving in the position of "Exchange Non-Member" as its members. Given Cantor's level of control over the Committee on Recordkeeping, this could allow the committee to "summarily dispose" of record keeping violations in favor of Cantor or Cantor's customers without the benefit of an unbiased member to oversee its activities. This is of particular concern since Cantor has entered into a settlement agreement with the SEC arising from violations of SEC record keeping requirements.[95]

The Committee on Recordkeeping is just one example. The CBOT has had insufficient time and information to analyze the composition of all major disciplinary committees of the CFFE and the rules that apply to them. Do the NYCE committees meet diversity requirements as those requirements apply to the CFFE? Do the CFFE committees meet diversity requirements? Has the Commission made a detailed analysis to ensure that the CFFE and NYCE have fair procedures? Does this novel, bifurcated system threaten that many disciplinary matters will "fall between the cracks"?

G. Dissemination of Market Data

Congress has declared the role of centralized markets in promoting price discovery to be in the national interest. However, in addition to the noncompetitive trading discussed above, the CFFE model could endanger price transparency through inferior price dissemination. The Applicants have presented no information regarding the audience for the CFFE's quotations, whether bids or offers, or perhaps only completed trade information, will be widely distributed. Will this information be disseminated only to Authorized Traders, or to customers as well, or to a wider audience? In addition, the Applicants have not described the timing or frequency of any such distribution to categories of potential recipients. Yet, while failing to properly disseminate prices itself, the CFFE may intend to free-ride on the CBOT's price dissemination without carrying any of the CBOT's costs or regulatory burden. If the CFFE does not widely disseminate its prices, the loss of transparency could weaken the reliability of prices at the CBOT and in other existing markets and could have a further negative impact on liquidity in those markets.

H. Public Interest Considerations: Price Discovery, Market Fragmentation and Unfair Competition

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[95] See, SEC News Digest, 94-50 (March 17, 1994).

Applicants have failed to meet the public interest test of Section 5(a)(7)of the CEA. They have not demonstrated, nor in our view can they ever demonstrate, that the CFFE's proposed Treasury futures contracts "will not be contrary to the public interest."

The Applicants have established the CFFE for the purpose of serving as a non-competitive or block trading network in CBOT Treasury futures contracts. If approved, the CFFE will have an unfair competitive advantage over the CBOT that will drain liquidity from the most successful complex of futures contracts traded in the world, thereby resulting in market fragmentation that will seriously weaken the ability of our markets to provide the reliable price discovery and efficient hedging that Congress has declared to be in the national public interest. The Treasury Department relies on the price discovery of the CBOT's Treasury futures to help manage the public debt and stabilize interest rates. Businesses rely on these markets to hedge their interest rate exposures. Diverting trades from our auction markets would undermine our ability to serve those national public interests. The Applicants, however, candidly admit their intentions to drain liquidity from the CBOT's contracts. In their marketing materials they state that "The similarity of the [CFFE's] initial contracts to existing Treasury futures contracts will enable market participants to apply their trading strategies seamlessly to the CFFE contracts."[96]

The CFFE proposal represents an attempt to get the CFTC to override the CBOT's decisions about how our markets should operate by seeking to clone the CBOT's contracts and trade them in a back room, block trading network shielded from public or regulatory scrutiny. Let there be no doubt, the Exchange would strongly oppose any such CFTC action.

If CFFE is approved, no successful exchange contract is safe. Even if the Chicago Mercantile Exchange does not want to allow Eurodollar futures to be block traded, for example, the CFFE tomorrow could decide to list those contracts on its block trading network. Thus, the policy and legal issues the CFFE Application raises are critical to the Commission's administration of the CEA and to the future competitiveness of centralized U.S. futures exchanges. These issues require careful study and thought. The Commission has established a framework for undertaking this analysis with its separate, parallel Concept Release on Regulation of Noncompetitive Transactions, which solicits public comment on these very issues. The Commission should wait until its has completed that analysis before making any decision whether to allow the CFFE proposal to proceed in its current form.

In many respects, our greatest fear is that the CFFE's numerous regulatory deficiencies cited above could lead to inevitable customer protection and market integrity issues. Those issues will have a spill-over effect on the Board of Trade. If the regulatory deficiencies and other troubling features of CFFE trigger customer protection problems, the public criticism will harm the CBOT as well as CFFE. In the public's mind, in fact, all futures markets, particularly U.S. Treasury futures markets,

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[96] CFFE Marketing Materials, p.1.

could suffer if regulatory deficiencies lead to a scandal of significant proportions. That is why all the issues we have raised must be answered before CFFE can be allowed to go forward.

IV. Clearing Uncertainties

Our analysis of NYBOC's clearing operations is incomplete, primarily because the record omits important information to allow us to fully evaluate the clearing component. We are especially troubled that the Commission has not received (nor apparently requested) a more complete description of NYBOC's default procedures or of the sources, level and liquidity of the financial resources NYBOC could draw upon to cover a clearing member default. These types of concerns were at the heart of the regulatory and industry efforts, immediately following the collapse of Barings Bank in February 1995, to minimize the impact of similar failures in the future on the financial integrity of clearing processes.

The Commission should be mindful of its own efforts in bringing together regulators from around the world at the Windsor Conference in May 1995 to develop a number of broad steps that the regulators could take to reduce systemic risk in the clearing system. In a parallel effort, the Futures Industry Association set up a Global Task Force on Financial Integrity (the "Task Force") comprised of exchanges, clearinghouses, brokerage operations and institutional customers from around the world to develop a number of specific steps that each category of industry participant could implement to reduce the level of financial risk associated with participating in the markets. In each project, the clearing process itself received close scrutiny.

One of the major recommendations that came out of the Task Force is that clearinghouses should publish information statements on their customer protection mechanisms, sources of financial support and default procedures so that customers can evaluate the comparative strengths of specific exchanges and their associated clearinghouses before deciding to trade on a particular market. The CBOT and Board of Trade Clearing Corporation ("BOTCC"), along with the Hong Kong Futures Exchange, took the lead in developing a standardized format for clearinghouses to follow in preparing their information statements. The format covers the special areas of concern identified by the Task Force in its published recommendations, with special focus on a clearinghouse's financial safeguards, financial resources to cover default (including both the level and the liquidity of those resources) and default procedures.

Given the widespread recognition of the need for financially robust and well-run clearing facilities to guard against systemic risk, the Commission should carefully analyze all aspects of NYBOC's proposed clearing operations. In particular, the Commission should ask for complete information on the level and source of NYBOC's financial resources to cover a clearing member default; the ready availability, i.e., the liquidity, of those resources, and the default procedures NYBOC would follow in the event of a clearing member default. As related issues, the Commission should also request clarification on NYBOC's relationship to the Commodities Clearing Corporation, the NYCE and Cantor, whether any Cantor entities that become clearing members will be treated the same as other clearing members, and the status of the CFFE's discussions with GSCC.

V. The Commission Cannot Legally Approve the Application in its Current Form

The information that Cantor and NYCE have provided in support of the application is materially deficient, especially in describing Cantor's role in CFFE's organizational structure and market operations. Moreover, based on the limited information that is available, it appears that CFFE's current plans are fundamentally at odds with the regulatory framework of the CEA and Commission rules. Of course, it is difficult to make a definitive determination on whether CFFE complies with all of the legal standards for contract market designation in the absence of a complete evidentiary record, which is why we recommend that the Commission hold hearings on the application. Before acting on CFFE's application, the Commission should develop a full factual record and allow for further review and comment based on more complete information by interested parties. Commission approval of the application in its current, materially incomplete, form would be arbitrary and capricious.

If, on the basis of a complete evidentiary record, the Commission determines that CFFE's proposal does not comply with the CEA and Commission rules, as we anticipate, then the Commission cannot legally approve CFFE's application for designation as a contract market for Treasury futures. At that point, CFFE has two choices: CFFE can either modify its proposal to conform to the same stringent requirements that apply to existing contract markets, or it can request the Commission to approve the application pursuant to its exemptive authority under Section 4(c) of the statute.

To date, the only exemptive relief the Commission has made available for contract markets is the Part 36 Rules. However, CFFE's current proposal does not fit within Part 36's exemptive framework for a variety of reasons. For example, CFFE has not excluded retail participation from its proposed markets; its proposed contracts are not cash-settled nor are they "reasonably distinguished" from the CBOT's Treasury futures products (in fact, CFFE's proposed contract terms are nearly exact replicas of the CBOT's); and its audit trail appears to be wholly inadequate.

Although the Commission could apply other exemptive standards to CFFE's application, it would be blatantly unfair for the Commission to do so without first making that alternative framework available to all contract markets. This is especially true given that the Commission has for over five years effectively ignored other exchanges' requests for a meaningful exemptive framework for offering less regulated contract markets in today's highly competitive global markets. The CBOT submitted a petition to the CFTC seeking an exemption for a "professionals only" market, called ProMarket, in June 1993. The Chicago Mercantile Exchange also filed a petition in 1993 seeking an exemption from the CEA for Rolling Spot futures and options. The Commission imposed a protracted comment and evaluation process on the exchanges' petitions, raising approximately 100 specific public policy questions and hosting an unprecedented round table discussion on the policy implications of the exchanges' rule proposals. Ultimately, the Commission effectively rejected the exchanges' petitions -- although the Commission has not formally acted on the CBOT's modified ProMarket petition which we filed in December 1994 -- and adopted the Part 36 Rules as an

alternative form of exemptive relief for exchanges despite extensive criticism from the exchange community that the rules are unworkable.

Against this history, we would expect the Commission, out of fairness, to defer granting more favorable exemptive relief to a brand new exchange with no track record, until the Commission has had an opportunity to reevaluate the entire issue of exemptive relief for exchange markets with the objective of developing a more meaningful framework than Part 36 that would be available to all exchanges. The exchanges' past criticisms of the Part 36 Rules are well-founded and there is much room for improvement. The rules are cumbersome and unworkable because they superimpose a substitute regulatory structure on the CEA's existing foundation. The CBOT has been hindered in our own strategic initiatives by the lack of effective exemptive relief for exchange sponsored markets. Thus, the CBOT would welcome the Commission's reconsideration of the exemptive standards available to exchange markets.

If the Commission decides to reevaluate its exemptive approach for exchange markets, there are certain basic conditions, supported by strong public policy considerations, that we believe the Commission should incorporate into any revised exemptive framework for exchange markets. These conditions are discussed at length in the CBOT's original ProMarket petition and in our December 1994 modification of the ProMarket Petition,[97] and include, among others, that:

1. The exemption should not be available for contracts that replicate non-exempt, fully regulated contracts; and

2. Transactions in exempt contract markets should be subject to anti-fraud and anti-manipulation rules enforceable by the CFTC and private participants in civil litigation.

The first condition is prudent and necessary to avoid harming established markets through market fragmentation and unfair competition. It should go without saying that a less regulated market, especially one that is designed to facilitate demands of large customers for execution facilities that do not expose their orders to competitive pricing, will draw order flow from the established markets they copy. This diversion of order flow will harm the price discovery and liquidity of the established markets. It is our understanding that the Commission was driven partly by these concerns when it adopted the "reasonably distinguished" limitation in the Part 36 Rules that effectively prohibits exchanges from offering exempt contract markets that are similar to non-exempt, fully regulated contract markets.

With respect to anti-fraud concerns, we urge the Commission to carefully evaluate whether it can, consistent with the public interest, adopt a framework that would accommodate a proprietary exchange concept such as CFFE proposes which is prone to abuse and favoritism and combines trade execution and trade surveillance under one roof; or that would allow an exempt contract market to

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[97] The CBOT proposed that CFTC oversight of exempt exchange markets should apply in ten areas altogether.

be controlled by a party who does not satisfy the Commission's registration fitness standards for market professionals. Perhaps it would be helpful for the Commission to consider how such a framework would apply to other exchanges. Would the Commission, for example, be prepared to grant the CBOT an exemption, patterned after CFFE's model, on the following terms?

1. The CBOT could transfer ownership of our wholly-owned subsidiary, the MidAmerica Commodity Exchange, to Ceres Trading Limited Partnership ("Ceres"), which has the CBOT as its general partner and CBOT members and member firms as its limited partners.

2. The size of the MidAm Board could be reduced to 13, and Ceres could appoint 8 of the directors, three as outside public directors, and the CBOT could appoint the remaining 5 (see "8" below)

3. The MidAm could restructure its trading operations to replicate cash market dealer and interdealer broker trading rooms.

4. The MidAm/Ceres could hire Ceres Limited Partners as "Terminal Operators" to execute customer orders in the trading environment and thereby circumvent floor broker registration requirements and insulate the traders from liability to customers for trading errors and from disciplinary sanctions for trading abuses.

5. The "Terminal Operators" could execute trades on behalf of public customers and also on behalf of Ceres.

6. Ceres could hire a trading advisor to trade on the new restructured MidAm markets for Ceres' own account, for the financial benefit of the CBOT members who are limited partners.

7. The MidAm could seek contract market designation in a copycat of the Chicago Mercantile Exchange's Eurodollar futures contract and in copycats of other established contracts offered by other exchanges, and offer them in a less regulated environment that will give an unfair competitive advantage over our competitors.

8. The CBOT would monitor the trading operations on the MidAm, but ultimate disciplinary authority would reside in a Ceres-dominated Board.

VI. Questions/Areas Where Additional Information is Needed

The preceding sections illustrate the numerous deficiencies in the information provided by the Applicants to support their application for contract designation for the newly formed CFFE. The CBOT specifically requests the Commission to obtain additional information from the Applicants

in the following areas. to enable the Commission and interested parties to fully and carefully evaluate the CFFE application.[98]

Ownership/Control of CFFE

1. Description of the level and source of capitalization of Cantor Financial Futures Exchange Holdings, L.L.C, ("Holdings") including any debt arrangements between CFFE and Cantor Fitzgerald & Co. ("Cantor") or its affiliates.

2. Organization chart illustrating the relationship between CFFE; Holdings; Cantor; CFFE. LLC and other Cantor entities, including percentage ownership.

3. Description of the nature and level of financial interest that Cantor or any of its affiliates has in CFFE.

4. Description of the nature and amount of any other financial compensation that Cantor or its affiliates will receive from CFFE for participating in or performing services for CFFE; e.g., whether Cantor Fitzgerald Securities Corp. ("CFS") will receive any compensation for providing employees to act as Terminal Operators.

5. Identity of investors and controlling entities in CFFE, LLC.

6. Identity of CFFE's initial board of directors and officers.

7. Identity of each individual and entity previously disciplined by the SEC or CFTC that is involved in the direct or indirect ownership or management of the CFFE.

8. Description of how the merger of the NYCE and CSCE will effect the CFFE proposal, including NYCE's various self-regulatory activities on behalf of the CFFE.

Ownership/Control of the New York Board of Clearing, Inc. ("NYBOC")

9. Identity of NYBOC's initial board of directors and officers.

Exchange Personnel

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[98] Many of the following questions are reflective of the same concerns outlined in the Commission's letter to Futurecom, dated March 24, 1998, which suspended consideration of Futurecom's application until Futurecom provides additional requested information and demonstrates that it meets CEA requirements. The list also modifies and expands upon the list of questions included with our April 3, 1998, extension request letter.

10. Description of Terminal Operator qualifications and responsibilities. as well as any restrictions on their activities as Terminal Operators, e.g., whether Terminal Operators are allowed to solicit futures orders or government securities orders for Cantor Fitzgerald Securities or other Cantor affiliates.

11. Description of how Terminal Operators will be compensated and by whom. including any incentive fee arrangements.

12. Since Terminal Operators are also employees of CFS, a description of their job responsibilities for CFS, including whether they will handle customer orders in government securities for CFS or may trade for CFS's account.

13. Description of the functions that Terminal Operators will perform that require registration with the NASD as Government Securities Representatives.

14. Information regarding compensation of Terminal Operators for non-CFFE activities they will perform for Cantor Fitzgerald Securities or any other Cantor affiliates including any incentive fee arrangements.

15. Information regarding qualifications, responsibilities and authority of the persons designated Supervisors over the Terminal Operators and the names and credentials of each Supervisor.

16. Description of how Supervisors will be compensated and by whom, including any incentive arrangements.

Trading Activities/Rules

17. Explanation of what constitutes "trading privileges" on the CFFE as that term is used in CFFE Draft By-laws, Section 36.

18. Explanation of any restrictions on who a Clearing Member or Screen Based Trader may designate as an Authorized Trader.

19. Clarification of whether a Clearing Member or Screen Based Trader may confer direct access to the CFFE Terminal Operators to their customers by designating employees or agents of their customer as Authorized Traders.

20. Description of any trading activities that Cantor, CFS or any other Cantor affiliates are permitted to conduct, either proprietary or for customers, on the CFFE.

21. Description of any restrictions on trading activities of Terminal Operators and Supervisors in other markets or on behalf of Cantor. CFS or other Cantor affiliates or their customers or an explanation for the absence of such restrictions.

22. Description of any cash market activities of any Cantor entities that will have access to CFFE trade information.

23. Description of any procedures to prevent improper flow of confidential or sensitive trade information between CFFE, on the one hand, and Cantor, CFS and other Cantor affiliates. on the other hand or an explanation for the absence of such procedures.

24. A more complete description of the execution process, from an Authorized Trader's receipt of a customer order; to placing of the order with a Terminal Operator; through the Terminal Operator's handling of the order, including especially the Terminal Operator's role in the execution process during the "Exclusive Time" and the "Clearing Time;" through communication of an executed trade back to the customer.

25. Description of the current execution facilities and processes at CFS and other Cantor entities and a point by point comparison of the same to CFFE's execution facilities and processes, including a comparison of existing work up practices to the Exclusive Time and Clearing Time concepts to be used for trading on the CFFE.

26. Explanation of when, other than in emergencies, the CFFE board may exercise the authority under CFFE Rule 300(c) "in its discretion, without previous notice, [to] close CFFE or any contract market thereof on such days or portions of days as will in the Board's . . . judgment serve to promote the best interest of CFFE."

27. Explanation of any policies or standards that apply to the Futures Committee's authority under CFFE Rule 314 to establish the settlement prices for CFFE futures contracts.

28. Explanation of any policies or standards that apply to the Futures Committee's authority under CFFE Rules 303-A and 314 to establish the match trade price for CFFE Market Crossing sessions.

29. Explanation of any policies or standards that apply to authority of the Committee on U.S. Treasury Securities Committee for setting Exclusive Time or Clearing Time sessions.

30. Explanation of any policies or standards that apply to authority of the Committee on U.S. Treasury Securities Committee for setting Market Crossing sessions.

31. Description of any CFFE rules or restrictions on block trading away from the CFFE's execution facilities or an explanation for the absence of such rules or restrictions.

32. Description of any CFFE rules or restrictions on pre-negotiation, i.e., prearranged orders that are submitted to the Terminal Operators or an explanation for the absence of such rules or restrictions.

33. Description of any CFFE rules or restrictions on dual trading or an explanation for the absence of such rules or restrictions.

34. Related to dual trading and insider trading concerns, a description of any CFFE rules or restrictions on Cantor, CFS or their affiliates participating in CFFE's markets given CFFE, LLC's control over CFFE and the Terminal Operators' status as joint employees of the CFFE and CFS, or an explanation for the absence of such rules or restrictions.

35. Clarification of whether EFP transactions are intended to accommodate large block trading in CFFE futures contracts; description of standards that apply to ensure bonafides of EFP transactions.

36. Explanation of how Terminal Operators will handle orders they receive for EFP transactions.

37. Explanation of the CFFE's role in executing orders for EFP transactions placed with the Terminal Operators.

38. Explanation of Cantor's role, if any, in executing orders for EFP transactions placed with the Terminal Operators.

39. Explanation of the record keeping and audit trail requirements that apply to EFP transactions.

40. Description of how the CFFE's trade practice rules and execution facilities meet competitive trading standards.

41. Explanation of when an order trade is deemed to be executed and when a trade occurs.

Audit Trail and Surveillance Procedures

42. A more complete description of the audit trail information that CFFE will capture throughout the entire end-to-end cycle and an explanation for the deficiencies cited in this letter.

43. Description of the accuracy and reliability of CFFE's audit trail information or any audit trail specific to an electronic environment (including during Exclusive Time and Clearing Time) and how CFFE's audit trail complies with the CEA and CFTC requirements.

44. Description of the surveillance programs that the NYCE will perform for CFFE and whose activity will be covered, e.g., whether NYCE will conduct surveillance of how the Terminal Operators handle and execute the orders they receive.

45. Description of NYCE's surveillance programs for monitoring activity that occurs through the electronic bulletin board.

46. Description of the role of the CFFE and NYCE in overseeing Authorized Traders in the following areas: books and records, financial reporting, examination process (if any).

47. Description of the structure of the NYCE surveillance department which demonstrates that it will be staffed with a sufficient number of people with appropriate credentials for the surveillance tasks required to carry out properly the CFFE's trade practice surveillance program, including the names, the functions and the credentials of each staff member.

48. Description of NYCE's surveillance programs for monitoring of EFP transactions involving CFFE futures contracts to confirm that they are bona fide EFPs.

49. Description of any special market or trade surveillance functions that NYCE will perform with respect to the trading activities of the Terminal Operators or Supervisors in other markets, whether for their own account or on behalf of Cantor, CFS or other Cantor affiliates or their customers.

50. Description of any special market or trade surveillance functions that NYCE will perform with respect to the trading activities of Cantor, CFS or other Cantor affiliates, whether as dealer for their own account or as broker on behalf of other customers.

51. Demonstration that NYCE has adequate resources to take on added surveillance responsibilities on behalf of CFFE.

52. An explanation of whether the following persons could have access to material, non-public information related to the futures contracts that trade on the CFFE: any Cantor entities or Cantor-affiliated entities; any individuals that own an interest in Cantor entities or Cantor-affiliated entities; any employees of Cantor or Cantor-affiliated entities; and any principals or employees of the NYCE or NYBOC. The Applicants should describe whether any of these persons that could have access to material non-public information related to the CFFE's contracts would be able to trade directly or indirectly on the CFFE.

Customer Protections/Grievances

53. Description of the fitness and financial standards that apply to Authorized Traders.

54. Description of customer recourse against CFFE for trading errors committed by Terminal Operators; justification for any disclaimers of such liability by CFFE in light of Commission requirements that exchanges provide an arbitration forum for customer grievances against exchange members, which includes grievances relating to trading errors or abuses.

55. Description of NYCE arbitration forum as it relates to trading activities on the CFFE, including potential claims against Terminal Operators.

56. Explanation of whether arbitration claims involving trading on the CFFE may be filed with the NASD.

57. Explanation why Terminal Operators should be excluded from reparations.

Reliability/Capacity of the CFFE Trading System

58. Reports on testing of the Cantor system, including mock trading and other beta testing performed by the Applicants to determine the system's accuracy and capacity and any audit trail capabilities, including all issues the Applicants encounter, the plans to address these issues, the progress being made to resolve these issues.

59. Description of whether CFFE has tested the accuracy and reliability of the electronic component of CFFE's execution facilities trading system, whether the testing was performed and the test results certified by a qualified independent consultant; whether the Cantor System complies with the relevant provisions of the IOSCO standards for electronic trading; and the results of any such testing.

Financial Integrity - Market Protection, Financial Resources, Default Procedures

60. Description of when the clearing guarantee attaches.

61. Demonstration that NYBOC's financial safeguards ensure the financial stability of the clearing system.

62. Description of events that could trigger a default or suspension of, or other extraordinary action against, a Clearing Member and the various actions that may be taken, including but not limited to freezing, transfer or close out of positions, and a brief description of how past defaults have been handled by the Commodities Clearing Corporation.

63. Description of the anticipated level and source of NYBOC's financial resources available to cover a clearing member default, including a description in each case of whether the resources are liquid or illiquid; and a description of NYBOC's default procedures given various default scenarios. This information should include:

- Description of the anticipated level and source of NYBOC's capitalization and evidence of its financial stability;
- How Clearing Members' market exposures would be forecasted based upon different levels of large market moves;
- How Clearing Members' exposures would be taken into account in assessing their financial soundness;
- How the financial condition of all Clearing Members will be monitored;
- How positions of defaulting members would be liquidated in an illiquid market; and
- How government securities deposited as margin would be valued, with a justification of any departure from the industry norm or haircutting the value of this form of performance bond.

64. Description of each operational aspect of the clearing process, including as applicable, frequency and timing information and the role of settlement banks, drawing appropriate distinctions between a Clearing Member's house and customer/client account (or clearing origin) at the clearinghouse, including:

- Trade entry and execution;
- Positions Accounting;
- Variation Settlement; and
- Settlement Process.

65. A description of how, at both the clearing member level and customer level, margin is calculated or set; acceptable forms of margin and valuation of margin (e.g. haircuts); where the margin is held; and the timing and frequency of margin calculations and payments.

66. A description of standards for clearing membership including the admission process, capital requirements, financial reporting, financial/operational oversight, and required financial contributions to the guarantee fund or otherwise.

67. An operations manual governing the clearing functions of NYBOC that would set forth among other things, the rights and obligations of the CFFE vis a vis NYBOC and the rights and duties of CFFE Authorized Traders in the clearing process.

68. A comprehensive diagram illustrating the flow of margin and settlement funds and settlement instructions and all other information between the CFFE and NYBOC for at least two business days of trading and settlement activity at the CFFE.

69. Description of the status of cross-margining discussions with the GSCC.

VII. Conclusion

Based on the inadequate factual record assembled to date, we know that Cantor Fitzgerald & Co., directly or through its affiliates, proposes to control a new futures market, CFFE, which is nominally owned by NYCE and its members. The system whereby orders will reach this new market is artfully described as an "electronic system," but is actually the same voice-brokered system Cantor uses for trading cash government securities and is apparently based upon the same cash market trading conventions. Order entry and execution are controlled by "Terminal Operators" who are dually employed by Cantor Fitzgerald Securities and CFFE. These Terminal Operators (whose precise compensation and incentive arrangements are unknown) perform virtually identical functions to floor brokers or associated persons but, by virtue of being called "Terminal Operators," evade (1) all CFTC registration requirements, and (2) all trading standards under Part 155 of CFTC regulations including prohibitions against disclosure of customer orders, inequitable allocation of customer orders, accommodation trading and dual trading.

In the absence of Part 155 standards, Terminal Operators will determine the manner in which to handle orders for customers and orders for their employer, Cantor Fitzgerald Securities, and its affiliates. Time stamping and other basic audit trail requirements are not proposed for the entry of such orders. Moreover, surveillance of the activities of these Terminal Operators is assigned to a two-person NYCE compliance staff which the CFTC judged incapable of executing its surveillance duties strictly with respect to existing NYCE markets only two months ago. That two-person staff has no known experience monitoring markets with voice-brokered and electronic components. Ultimately, that compliance staff will report to a board of directors that is controlled by Cantor.

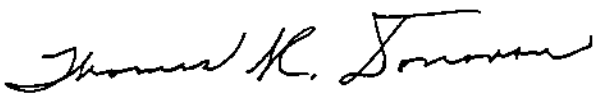
Thus, as proposed, Cantor will control the market; Cantor will trade on the market; Cantor will employ the individuals who control the entry of customer and Cantor orders into the system: and Cantor will ultimately control the decisions whether customer orders have been abused and how the market's minimalist rules should be interpreted and applied. The "work-up convention" and other protocols which will govern the entry and execution of orders are fundamentally non-competitive. in violation of CFTC regulations. Finally, Cantor seeks such contract market designation for CFFE after having settled CFTC charges involving customer fraud within the last 15 months.

In short. it would be difficult to construct a scenario more fraught with conflict and the potential for customer abuse than that contained in the CFFE Application.

Additionally, the Application fails to provide for meaningful resolution of customer grievances, to meet stringent audit trail requirements imposed on all U.S. exchanges, to comply with the diversity requirements for Board representation and to provide appropriate disclosure to customers of the risks and conflicts inherent in the proposed market. For these reasons, the proposed market does not meet the requirements for contract market designation set forth in Sections 5 and 5a of the CEA. Moreover, information on the organization and operation of NYBOC, the entity which will clear CFFE trades, is utterly lacking despite post-Barings efforts led by the CFTC to improve disclosure respecting futures clearinghouses.

Were all of the above deficiencies and short-comings corrected, the Commodity Exchange Act nonetheless does not contemplate and, barring CFTC exemptive action under CEA Section 4(c), cannot accommodate the kind of proprietary exchange model which the Applicants are proposing. If, as we have consistently urged, the Commission decides to consider further exemptive relief for contract markets generally, beyond the very limited provisions of Part 36, the CBOT would welcome the opportunity to submit its views .

Respectfully submitted,



Thomas R. Donovan,
President and Chief Executive Officers

EXHIBIT A

CFFE EXCHANGE MODEL

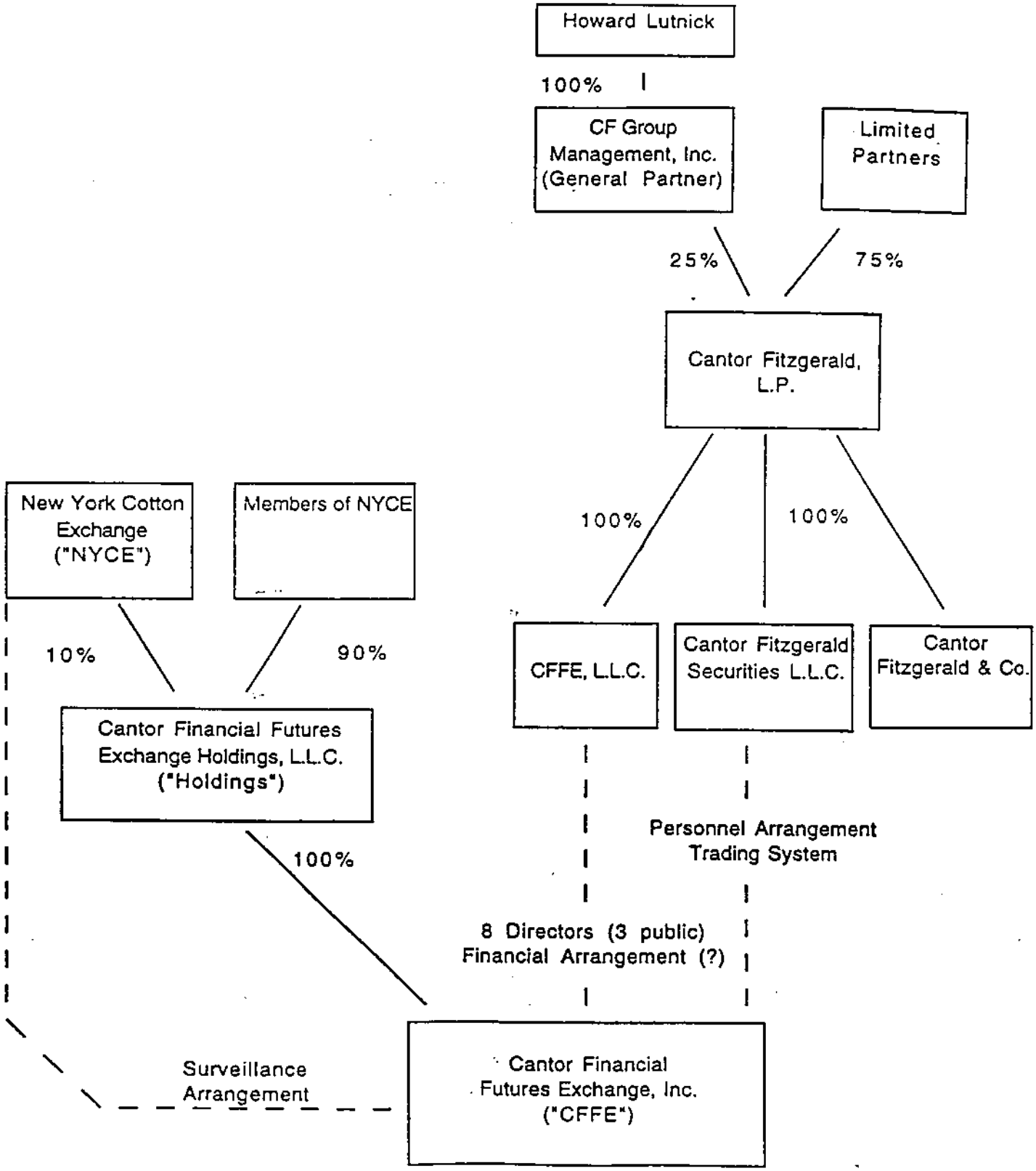
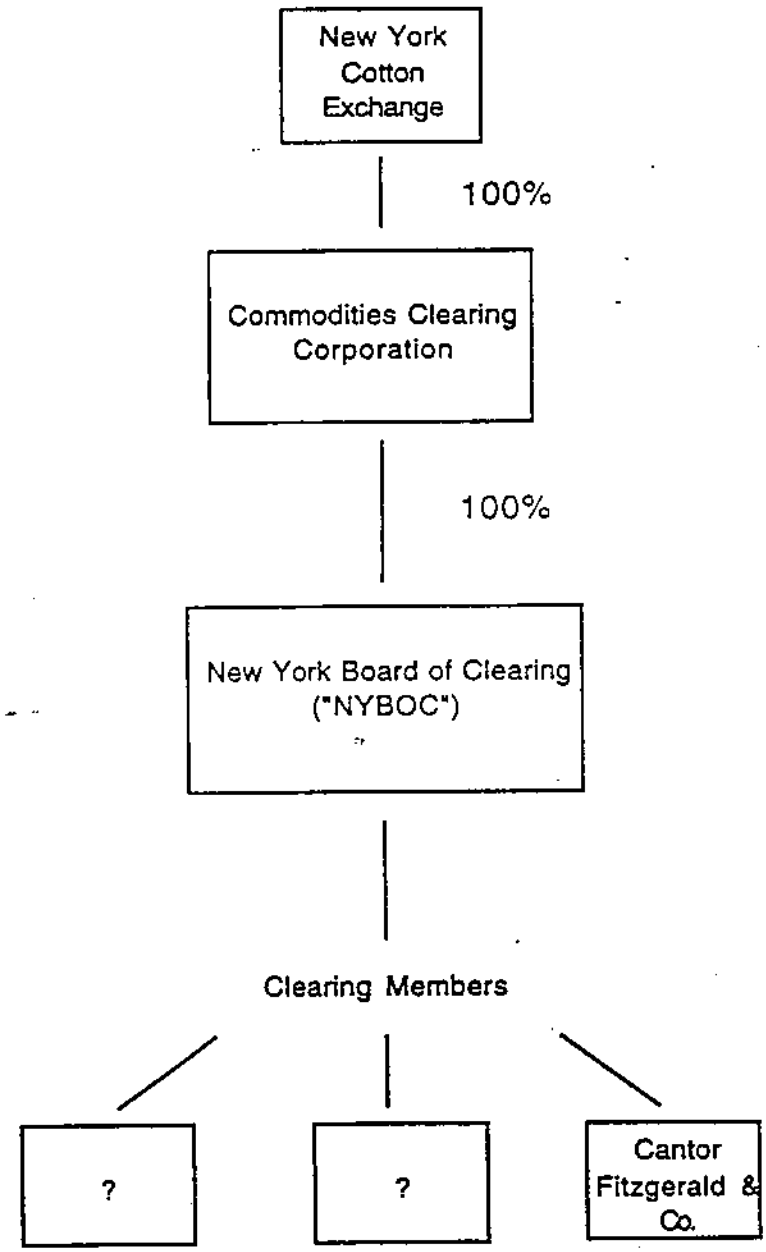


EXHIBIT B

CLEARING STRUCTURE



Cantor Financial Futures Exchange

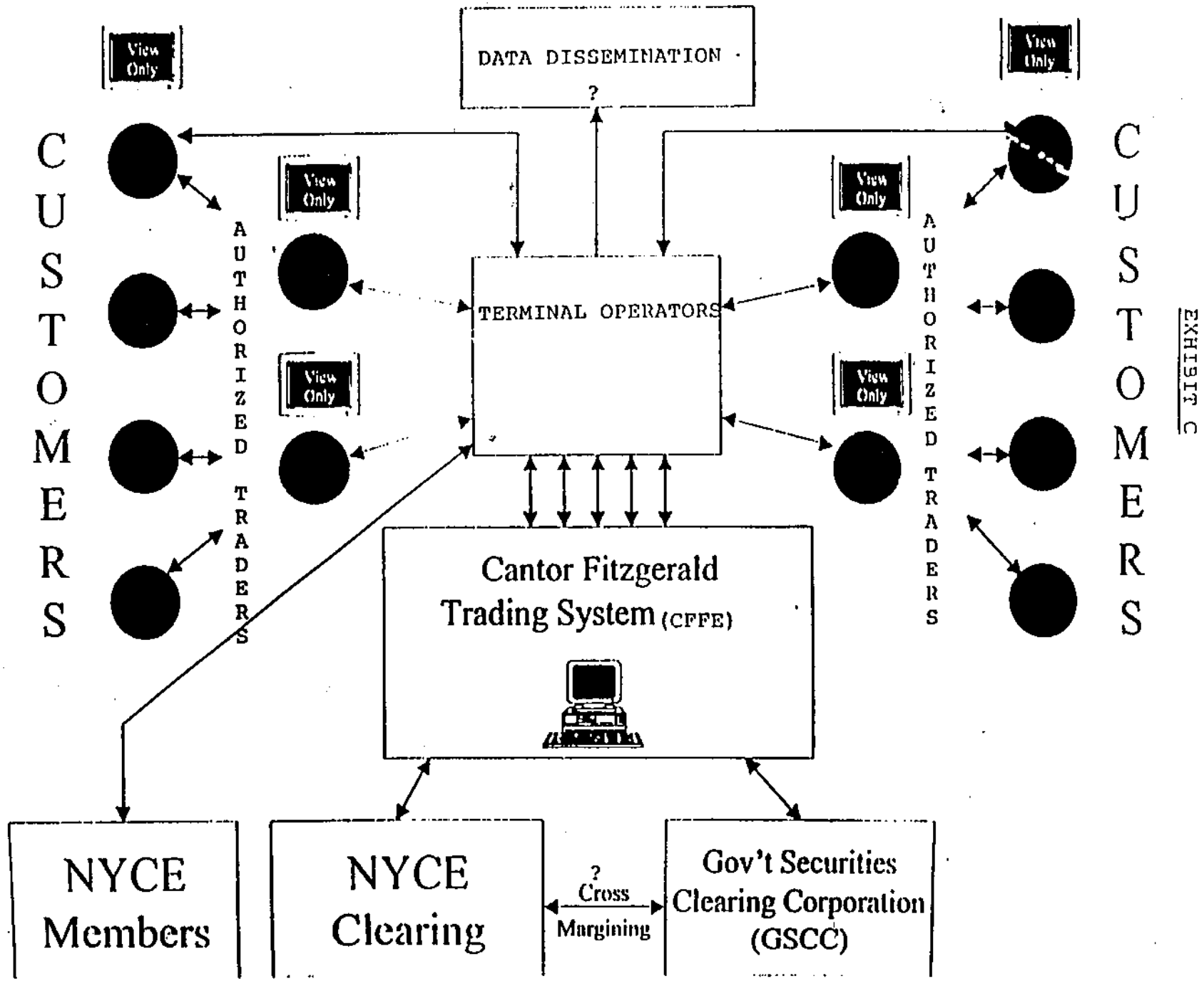


EXHIBIT C

EXHIBIT D

ıd the wallpaper

From Cantor Fitzgerald's 105th-floor offices Howard Lutnick chases global ambitions—but there's a slightly sour odor emanating from his brokerage house.

...Chief Howard Lutnick
...master of the universe—for now.

By Thomas Jaffe

AT 36, HOWARD LUTNICK is the youngest chief executive of a major Wall Street firm. From his lofty perch on the 105th floor of New York's One World Trade Center, the managing general partner of Cantor Fitzgerald, L.P., can peer down on the lesser skyscrapers that house far bigger and better-known brokerages. Though it dominates the brokering of U.S. government bonds, Cantor is no Merrill Lynch or Morgan Stanley, Dean Witter Discover or Goldman, Sachs. But never mind—Lutnick has ambitions as towering as the aerie he occupies.

Cantor has come up as a niche player. In a single day, on average, $100 billion in U.S. government debt is traded through brokers like Cantor, which reigns supreme in brokering long bonds—30-year maturities. It also is a major broker for other segments of the Treasury market. Not least, it supplies the Treasury bond pricing data that are the bread and butter of Dow Jones & Co.'s electronic information service.

Though the Cantor partnership's capital of $185 million is only a pittance compared with Morgan's $13 billion or Goldman's $5.8 billion or, soon, the $9 billion of Travelers' Salomon Smith Barney, Lutnick is expanding Cantor into a supermarket of wholesale brokerage services in all kinds of

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Bernie Cantor had money and power. Howard Lutnick wanted them, too...

fixed-income paper, foreign exchange, derivatives, futures and interest rate swaps. And it is in equities with institutional sales and trading. Cantor already employs over 2,300 people—more than half of them at its New York headquarters, about 675 in London.

A nondescript man of average height with thinning black hair, Howard Lutnick has come a long way from the modest home on Long Island, where he grew up as one of three children of a college professor. With his 40th birthday still nearly four years away, Lutnick already boasts membership on the executive board of the Nasdaq stock market and sits on the board of managers of his alma mater, Haverford College. Lutnick, his lawyer wife and their 18-month-old son live in Manhattan's showy Trump Palace, where they are served by an English butler.

His social ambitions match his business ambitions. This summer the Lutnicks vacationed at the ritzy Grand Hôtel du Cap Ferrat on the French Riviera, in a $42,000-a-week villa.

...s and Bernie Cantor
The Park Avenue-Beverly Hills high life.

His mentor

Lutnick bootstrapped himself from obscurity by being useful to now-legendary Wall Streeter B. Gerald Cantor. When Bernie Cantor died last summer, at 79, he was buried in the small Los Angeles cemetery in which Marilyn Monroe lies. His fortune was estimated at $500 million, and his art collection was world-famous for its hundreds of Rodin sculptures.

Cantor's was a classic rags-to-riches tale. As a poor teenager in the Bronx he hawked hot dogs at Yankee Stadium. He quit New York University to become a broker, served as a paratrooper during World War II and in 1945 founded his own securities firm in New York. But it was in Los Angeles, the entertainment capital of the world, that he made his mark, numbering Kirk Douglas and Zsa Zsa Gabor among the clients of his Cantor Fitzgerald & Co. (Fitzgerald, long gone, was an early associate.)

Long term wasn't Cantor's style. He kept moving around, looking for an edge. Arbitrage was his real love—small, quick profits with little or no risk. Cantor knew his way around the convoluted tax code, and his interpretation of its finer points made him a master of tax shelters, straddles and other such schemes. Besides collecting Rodins, Cantor collected politicians. He and his wife, Iris, were among those to rent a room for the night at the Clinton White House.

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Many in the securities industry are like Bernie Cantor, prowling about for an edge, but Cantor broke from the pack of edge-seekers in 1972. The equities business was crowded, and, save for the Nifty Fifty, equities were drooping. The government bond market was less crowded and—handily—less tightly regulated.

Sensing opportunity, Cantor invested about $3 million in Telerate, an electronic data service that disseminated commercial paper interest-rate information. He also opened Cantor Fitzgerald Securities Corp., a wholesale broker-dealer of government securities now registered separately from his Cantor Fitzgerald & Co.

The way the government securities market had worked until that point was that wholesale brokers like Cantor arranged trades between primary dealers. The primary dealers dealt with retail customers—retail being in this case not the general public but big institutions, financial houses, large hedge funds and the like.

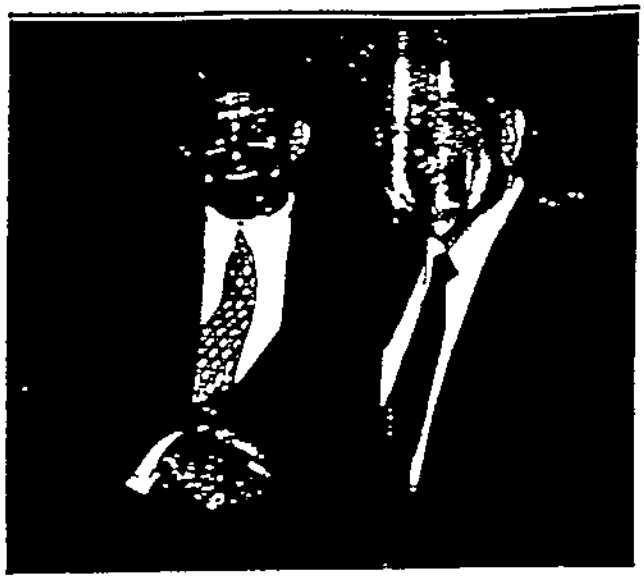
There are currently around 35 primary dealers, mostly huge firms like Salomon, Merrill Lynch and Lehman Brothers. Why do they need wholesale brokers? To cover their tracks. The lion's share of the volume in government securities comes from the primary dealers trading amongst themselves. If a primary dealer is liquidating a huge position, it doesn't want that fact known, lest others, smelling a huge sell order, try to crowd ahead of it. By going through a wholesale broker, the primary dealer expects anonymity.

Enter Cantor. As a wholesale broker, Bernie did what his rivals hadn't thought of. He made the market more efficient by putting the bids and offers from primary dealers on Telerate's screen network. This made the market more transparent but preserved anonymity.

Today there are plenty of other bond quote

So Lutnick did the old man's bidding, and then just rolled right over him...

screens. But when Cantor first got into it, Telerate was an innovation. It filled a gap. Through the Telerate network of screens everyone could see—more or less in real time—what was going on in the Treasury market, though they couldn't see the names of the players. Cantor's timing was exquisite. Stocks were soon to turn dull, and they were to remain so for a decade. But as the federal deficit swelled, the government bond market boomed. Cantor moved in deeper, soon doing business directly with larger retail customers as well. He sold his controlling stake in Telerate for a huge profit in the early 1980s, but continued to milk it by charging it for the data Cantor supplied. Though the operation turned into a disaster for Dow Jones, it was one of the best things that ever happened to Cantor.



Howard Lutnick and Bernie Cantor
Cut from the same cloth?

Bernie's boy

Into this lucrative setup stepped young Howard Lutnick in 1983. Whereas Bernie had dropped out of college, Lutnick had a degree in economics from prestigious Haverford. But just a bit underneath the patina the young man and the old man were much alike. Cantor liked the kid. When he was just 24, an age when many young people are still in graduate school, Lutnick was trading for some of Cantor's personal clients. That was in 1985.

That same year Cantor let Lutnick start the Investment Strategies Group division of Cantor Fitzgerald & Co. Cantor was moving further down the distribution chain in the Treasury market, now dealing directly with retail customers such as regional banks, medium-size businesses, wealthy individuals and others.

In December 1990, when Lutnick was only 29, Cantor named him his second-in-command and designated successor. "Bernie wouldn't hear a bad word about the kid," says an ex-Cantor executive. "If you presented him with evidence that Howard had crossed the line, he'd say, 'Don't worry. He's young. He'll learn.'"

If he himself had not been the victim, Bernie Cantor might well have admired the way Lutnick grabbed control of Cantor Fitzgerald as his mentor lay dying.

In 1990 Cantor, in his 70s, went on dialysis. By 1994 he had been declared legally blind. Lutnick convinced him to change the firm from a corporation into a partnership, to avoid double taxation. The deal closed in September 1992.

Cantor had started with a 73% stake, but he and his stylish wife, Iris, took out profits to finance their high living. (By the time Cantor died, he owned just 47%.) The partnership structure still gave him absolute power; though Bernie's days were numbered, Lutnick apparently was getting antsy. He made an ally of Stuart Fraser, Iris Cantor's nephew, naming him head of the firm's government securities brokerage. In 1995 Lutnick, Fraser and a third partner tried to buy out the Cantors, but Bernie was still able to say no.

But on Jan. 2, 1996, when Bernie Cantor had been put on life support, Lutnick made his move. He activated the five-member incapacity committee provided for in the partnership agreement. Three members voted to take the reins from Cantor's failing hands; Iris Cantor and the fifth member abstained. Howard Lutnick, though he held just 14% of the partnership, was now the boss.

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Iris Cantor, newly in charge of the holding company through which Bernie owned his partnership units, was furious. Lutnick has claimed she wanted to sell the firm. Iris claimed that she merely wanted a say in operating it. In May 1996 they went to Chancery Court in Delaware to have it out. After two days they settled. Lutnick won: Iris Cantor would get a lot of money but have no voice in running the firm. When Bernie was buried two months later, Iris barred Lutnick from the cemetery.

A master of the universe

If Lutnick grieved, it wasn't for long. The weekend after his mentor's death, Lutnick and a crowd of guests celebrated his 35th birthday by gambling for charity at New

But try as he must, Lutnick can't get out from under his mentor's shadow...

York's Metropolitan Club.

Lutnick was by now—in novelist Tom Wolfe's felicitous phrase—a master of the universe.

What gives Lutnick and the firm clout in an investment world dominated by far bigger and more respected firms? Certainly not prestige. Its clout derives from its highly specialized position. This is a business in which margins are so thin that it takes real expertise to make money on them. Lutnick likes to refer to it as "getting between the wall and the wallpaper."

Home at the Cantors
Where Lutnick climbed and climbed.

The wholesale market in government securities operates in price increments as small as ¼₂ of a point, which translates to $39.06 on $1 million worth of bonds. In the retail market, increments typically are in ⅛ of a point, translating to $312.50 per million. Commissions? A primary dealer that trades through Cantor's wholesale government securities brokerage operation normally pays a commission of $30 per $1 million. The customers of Cantor's retail arm would pay a minimum commission on their trades of $39 per million. There's not a lot of paste between that wallpaper and that wall.

There is, however, a hell of a lot of wall and wallpaper. These tiny margins are worth pursuing because the market is so huge. In a market where $100 billion a day is traded, even $30 per $1 million comes to $3 million.

If you can wring a few extra pennies on a business in the billions, you've got real money. Think of it as highly sophisticated coin-clipping—a clip here, a clip there, often so tiny as to be unnoticed across trillions of coins.

Lutnick's critics say he has not always been scrupulous in getting between the wall and the wallpaper. Here's one episode about which FORBES has seen the relevant documents: In the late 1980s a U.S./German outfit, International Participation Corp., was running investment money for 6,000 European investors, mainly Germans. Indianapolis-based Vancorp Financial Services took on the management of $29 million of the capital. Vancorp opened an account at, among others, Cantor Fitzgerald & Co., trading mostly in Treasury bonds and over-the-counter options on Treasurys.

From late May to September 1989 the Cantor account lost $3.1 million and, elsewhere, futures accounts lost $1.1 million, yet Vancorp collected over $4 million in commissions and fees. When Vancorp returned the IPC funds to Germany that fall, only about $17 million of the $29 million was left.

So complex was the bookkeeping—and so convoluted the trail—that it took until May 1994 for the Commodity Futures Trading Commission to file a complaint. In January 1997 Cantor agreed to pay a $500,000 fine to settle CFTC charges that it had assisted in fraud.

But the German investors are still suing Cantor Fitzgerald & Co. for fraud and asking for more than $7 million in damages, plus three times that in punitive damages. The case is scheduled to go to trial Nov. 18 in federal district court in Los Angeles.

Extracurricular gains?

Where was the alleged fraud? The suit alleges Cantor agreed to broker Vancorp's trades for $156.25 per $1 million face value of Treasury bonds but in most cases collected almost three times that. It also alleges that Cantor acted not as a broker but as a dealer, without disclosing it to the client. Cantor denies the charges.

Howard Lutnick personally executed Vancorp's orders. His trading was conducted through three inventories—H, W and L—the initials for Howard William Lutnick.

FORBES has reviewed trading records relevant to the case. On Aug. 4, 1989 for instance, Cantor made a $150,000 profit (before commission) on a trade involving $20 million of long bonds that it purchased from Vancorp on the same day. In a trade this size the straight brokerage commission due Cantor at the agreed-upon $156.25-per-million rate would have been just $3,125. Did Vancorp's customers get full value for

Say this for Bernie—he was an innovator. Lutnick is not...

their bonds?

FORBES examined hundreds of transactions in which securities were traded between Vancorp and Cantor Fitzgerald & Co.'s Investment Strategies Group, and between ISG and other entities, most typically Cantor Fitzgerald Securities' government securities brokerage. They involved some $4.75 billion worth of positions and included over 80% of Vancorp's trades with Cantor.

Howard Lutnick and Iris Cantor **Smiles no more.**

Cantor defends its outsized gains on these transactions as simple reward-for-risk. But in the transactions reviewed by FORBES Lutnick lost money only about one time in ten. Cantor's take from the trades we examined was around $2.8 million. Close to half of that was rung up in four house inventories, almost all of it by H. W and L. Lutnick has admitted to a 30%-to-40% interest in the trading profits of those inventories. The other $1.5 million or so was credited as gross commissions to the salesman who covered the Vancorp account. After the salesman took his cut of that $1.5 million, Lutnick got a big chunk of what was left over.

The Vancorp account yielded profits in other ways. Cantor collected over $1.2 million of net interest. There were foreign exchange consulting fees. Commissions were rung up when house inventories sold positions acquired from Vancorp. Getting between the wallpaper and the wall? Cantor seems to have made quite a bit of space for itself in these transactions.

There are many, many ways to play the Treasury bond market. Howard Lutnick was well-versed in "rolls." What are rolls? A roll trade takes place between the day the Treasury announces it will auction off a new issue of a government security and the day the auction occurs.

Bond traders thrive on playing the spreads between existing securities of comparable yield and maturity and the forthcoming issues. Lutnick needed to figure out how to use Cantor's edge. According to a number of ex-Cantorites, for a time Lutnick and his Investment Strategies Group traders had access to the internal screens that the wholesale brokers used in Cantor's government securities broker[illegible] rooms. At the bottom [illegible] those screens is [illegible] crawl known as a water[illegible] that shows, by [illegible] number, which [illegible] have been the buyers [illegible] sellers in the last [illegible] trades in a given secur[illegible]

The brokers [illegible] waterfall to keep track [illegible] the order flow. But kn[illegible] ing who is doing the tr[illegible] ing is a clue to how big [illegible] well-informed the [illegible] may be. Is it a prim[illegible] dealer like Lehman? Is [illegible] smart hedge fund [illegible] George Soros' Quantu[illegible] Or just a large compa[illegible] investing surplus cash? The customers [illegible] not supposed to have this information.

Cantor denies that the traders in Investment Strategies Group ever had access to [illegible] waterfall, but that is flatly contradicted [illegible] several former Cantorites. James Avena [illegible] now the president of New York-based T[illegible] lett & Tokyo Securities, but from 1982 [illegible] 1990 he ran Cantor Fitzgerald Securiti[illegible] Avena says he told Bernie Cantor that L[illegible] nick and his crew were peeking at the wa[illegible] fall while trading. Cantor put a stop to [illegible] Avena says.

Cantor denies that traders in the Investment Strategies Group had access to the waterfall, but that is contradicted by several ex-Cantorites.

First Nevada first

Howard Lutnick kept looking for other w[illegible] to leverage the franchise. In the late 198[illegible] Bernie Cantor did not want to use his firm[illegible] scarce capital for trading, but he was willi[illegible] to let Lutnick trade on his own. So Lutni[illegible] set up Solomon Partners, a private tradi[illegible] partnership named for his father. It was op[illegible] from 1988 to 1990. He must have do[illegible] well, because Cantor soon wanted a bigg[illegible] piece of the action. In 1990 Lutnick creat[illegible] a better-capitalized private partnership, Fi[illegible] Nevada Associates, with most of the cap[illegible] coming from Bernie Cantor.

Though in theory First Nevada was a se[illegible] arate entity, it functioned like a house inve[illegible] tory for Cantor Fitzgerald & Co.'s Inve[illegible] ment Strategies Group. When it w[illegible] inconvenient for Cantor Fitzgerald to ca[illegible] a position on Cantor's books, it might [illegible] carried on First Nevada's. Or First Nev[illegible] might be used to process a transaction

book a profit. First Nevada was active from October 1990 through December 1992. Between its founding and mid-March 1992, the account generated over 1,000 pages of transactions, nearly all of them in U.S. government securities.

Was First Nevada a sham account, a way for the house at times to covertly trade for itself against customers? Cantor Fitzgerald has always maintained that First Nevada was an independent customer of the firm. Yet several times in January and February 1992 First Nevada's profit-and-loss position was noted in the margin of Cantor Fitzgerald & Co. blotters exactly the same way that such notations were regularly made for the house's alphabetical inventories. On many days First Nevada's trading easily made it Investment Strategies Group's biggest customer.

Gary Lutnick
Following in his brother's footsteps.

On Mar. 11, 1992 the *Wall Street Journal* broke the story that the Securities & Exchange Commission was investigating Cantor. A month earlier the brokerage statement covering First Nevada's trading was a record 191 pages long. The day after the story broke, First Nevada abruptly stopped trading on margin. Over the rest of 1992 the account was wound down.

In 1994 the SEC made Cantor Fitzgerald & Co. cough up $90,000 in profits and interest and fined it $100,000 for poor record-keeping in connection with a complex scheme to accumulate risk-free positions at Treasury bond auctions.

Gary Lutnick, 32, Howard's younger brother, joined the firm in 1991. He has run the trading team of Cantor's Global Trading Strategies group, the renamed Investment Strategies Group. According to people who worked with him over the years, Gary developed a clever way of squeezing a bit extra for the franchise. A retail customer would make an offer to buy long bonds. If there was a flurry of buying in the bond, Gary would sometimes grab bonds on the screen in front of the customer and then sell the customer his newly purchased bonds at a slightly higher price—again getting between the wall and the wallpaper. He could do that because customers see the trading screen, but don't see who bought the bonds ahead of them.

Anxious to dispel rumors that Cantor's government securities brokerage was giving Gary Lutnick better execution for his trading than it gave to its other wholesale customers, the firm this year hired Richard Breeden, a former chairman of the SEC, to investigate. Breeden told FORBES that the electronic trade-matching system Cantor installed in its government securities brokerage rooms last year made the possibility of such preferential treatment remote.

But Breeden admits his inquiry was "fairly narrowly focused." He says: "We came in and looked at the way things run today. We did not go back and look at the last two years, five years, ten years, to inquire."

All that Breeden's "fairly narrowly focused" probing proves is that nothing fishy was going on while he was looking. A half-dozen former staffers of Cantor's renamed Global Trading Strategies Group have told FORBES that over the years the firm frequently traded ahead of its retail customers.

Breeden admits his inquiry was fairly narrowly focused. "We looked at how things run today. We did not go back and look at the past too."

A Japanese bank gets a hosing

Howard Lutnick's efforts to win respect for Cantor Fitzgerald keep hitting the wall. In early 1996 there was the case of Cantor and Tokyo-based Norinchukin Bank, Japan's leading financial institution for agricultural cooperatives. The Japanese bank took a real hosing on some overnight orders it left with Cantor to fill. Did Gary Lutnick wield the hose? Sources tell us he did.

In its trading of U.S. Treasurys, Norinchukin favored what is called a scale trade. This means you buy a bit at a time, hoping that the market will be temporarily weak and let you lower your average cost. You can do this by putting in an overnight buy order on a descending scale. That can be dangerous on a volatile day.

Apr. 5, 1996 was such a day. It was Good Friday, when the market was open only half a day, and unemployment numbers were due out that morning. As it

turned out, unemployment had dropped, which was bad for bonds. The long bond slumped sharply, losing around two points.

Gary Lutnick, our source says, had an order to buy nearly $1 billion worth of long bonds for Norinchukin on scale-down. Instead of filling the order as the price fell, the source says, Gary waited until the bond had dropped considerably, then bought bonds and sold them to Norinchukin at the higher prices specified in the scale order. Our source says he made the house roughly $800,000 in a matter of hours.

The Norinchukin Bank won't say much about the April 5th episode, but in mid-1996 it quit trading Treasurys in limit orders—and sharply cut back its business with Cantor.

Cantor Fitzgerald won't comment on the Norinchukin trading, but it did provide FORBES with a copy of an interoffice memo on its trade execution policy for customer level/limit orders. It was dated May 9, 1996, just a month after the alleged Good Friday incident. Personnel of the then Investment Strategies Group were instructed to explain the policy to their customers.

In the letter, after the usual boilerplate Cantor clearly warned: ". . . while holding your unexecuted order, we may trade for our own account at prices that are equal to, or better than, your level/limit." Isn't that a frank admission that it reserved the right to front-run customers? Front-running is of course illegal in stocks: In Treasury bonds it's a gray area.

Has Cantor Fitzgerald cleaned up its act, as Richard Breeden's findings would suggest? In a June 24, 1997 letter to FORBES, Cantor said that its policies and procedures forbid brokers in its government securities brokerage to take positions. Yet on June 9 of this year, according to sources, Timothy Coughlin, a star Cantor broker of ten-year notes, took a large position on which Cantor wound up losing an estimated $1.5 million.

We could go on and on with examples of transgressions and alleged transgressions we have uncovered in more than a year of research on Cantor Fitzgerald.

Since Lutnick took over Cantor's [illegible] management in 1991, its revenues have tripled, to nearly $600 million last year, due in part to all the new businesses he's gone into. Keep this in mind, however: The growth was financed from profits from government bond brokerage, the equities business and income received from the sale of pricing data (a revenue flow the firm shares with an outfit now controlled by Iris Cantor). Many of those new businesses lose money or don't make much. European operations, led by the huge London office, gush red ink.

In short, Lutnick has yet to prove that he can turn Bernie Cantor's specialized money machine into a profitable full-service Wall Street house.

Howard Lutnick
Hobnobbing with fellow masters of the universe.

Lutnick has yet to prove that he can turn Bernie Cantor's specialized money machine into a profitable, full-service Wall Street house.

Skating on thin equity

Net profits rose during Lutnick's first years in charge, but from 1994 to 1996 they dropped from around $80 million to under $60 million. This year so far has seen another drop in profits, in part because of Lutnick's breakneck expansion.

Howard Lutnick's ambitions are huge but thinly capitalized. As of Mar. 27, 1997, there were $7.9 billion of assets but only $185 million of partners' capital.

The equity base looks even thinner when you realize that much of it is borrowed money. Last year the partnership retired a big chunk of Iris Cantor's partnership units and then it reoffered units to Lutnick and other partners; Lutnick's share is now 25%. Financing for the deal was provided by a Chase Manhattan-led syndicate. Thus Lutnick's partnership units—as well as those belonging to many other partners—are pledged as security for the loan.

Just as we were preparing to go to press, after months of reporting on the story, we received a press release from Cantor Fitzgerald. It announced the firm was, among other changes, shutting its fixed-income trading unit, Global Trading Strategies, Howard Lutnick's old stamping ground and more recently Gary Lutnick's. The announcement said the firm would concentrate on executing trades for customers. We note the irony without comment.