COMMENT

ISSUES FOR CFTC CONSIDERATION

AUG 12 12 17 PM '98

ISSUE #1

IF A FIRM IS A PROVEN WRONG-DOER AND ADMITTEDLY COMMITTED A DISCIPLINARY OFFENSE AS DEFINED IN CFTC RULE 1.63, WOULD IT BE CONTRARY TO THE PUBLIC INTEREST OR CFTC RULE 1.63 TO ALLOW THAT FIRM TO CONTROL AN EXCHANGE BY APPOINTING 8 OUT OF 13 MEMBERS TO THE EXCHANGE'S BOARD OF DIRECTORS?

THE CANTOR EXCHANGE VIOLATES
THE FITNESS REQUIREMENTS OF FEDERAL LAW.

Federal law prohibits any person that has committed a disciplinary offense from serving on the board of directors of a futures exchange for three years. The Commodity Futures Trading Commission found Cantor Fitzgerald & Co. to have committed a disciplinary offense in January 1997. But the Cantor firm now has applied to the CFTC to appoint a majority (8 out of 13) of the members of the Board of Directors of the proposed new Cantor Financial Futures Exchange. **Allowing Cantor to control the proposed exchange's board on which it would not even be eligible to serve would make a sham of the three year ban and the statute's "public interest" test.** Yet the CFTC has turned a deaf ear to that concern and instead appears ready to approve the Cantor Exchange application this summer. That approval would eviscerate the fitness requirements for exchange boards that Congress and the CFTC adopted so recently. The Commission should enforce the law consistent with the public interest and deny the Cantor Exchange's application.

Background and Summary

Like other corporations, futures exchanges are run by boards of directors. In 1989, the House Agriculture Committee heard "complaints that service on the governing boards of . . . contract markets and self-regulatory organizations by proven wrong-doers creates, at best, an image of leniency in the regulation of the markets." H.R. Rep. No. 101-236, 101 Cong. 1st Sess. 19 (1989). *See also* H.R. Rep. No. 102-6, 101st Cong. 2d Sess. 23 (1991). To remove that concern, Congress and the CFTC have combined to adopt a simple rule "to ensure the protection of the public and fairness to persons in the industry." Id. That rule is now codified in CFTC Rule 1.63 and provides -- *any person subject to a disciplinary offense -- a "proven wrong-doer" to use the House Committee's words -- is disqualified from serving as a member of an exchange's board of directors for a three year period.* That three year ban is hard and fast. No exceptions have been allowed. Until now.

The proposed Cantor Financial Futures Exchange is purposefully designed to skirt Rule 1.63. Last year, Cantor Fitzgerald & Co. was found by the CFTC to have aided and abetted a fraudulent scheme, fined $500,000, and ordered to cease and desist violating the Act's antifraud provisions. Despite this undisputed disciplinary offense, Cantor asserts it may now appoint 8 of the 13 members of the board of directors of the Cantor Exchange. In other words, although the Cantor firm is a "proven wrong doer" and could not serve on any exchange's board until the year 2000, Cantor is asking the CFTC to approve an application that would allow Cantor to control its new Exchange by appointing a majority of the Exchange's board of directors.

What does the CFTC say to this? Nothing. In the six months since the Cantor Exchange application was filed, the Commission has seemingly embraced the Cantor Exchange's mockery of Rule 1.63, a rule the CFTC told Congress in 1991

"enhances the actual and perceived integrity of the SRO's."[1] Despite written public comments raising the Rule 1.63 deficiency, the Commission has never once asked the Cantor Exchange for even a justification of its disregard of that Rule. Nor has the Commission indicated in any of its requests for comments on the new exchange that Rule 1.63 even poses a material issue.

The Commission's lack of concern is hard to explain. No one could seriously maintain that an individual "proven wrong-doer"serving on an exchange's board creates an intolerable perception of impropriety but allowing a firm that is a "proven wrong doer" to appoint a controlling majority of an exchange's board creates no perception of impropriety. That kind of form over substance makes a mockery of Rule 1.63, a rule the CFTC adopted, in its own words, to preserve the "actual and perceived integrity" of exchanges since the mere presence of a single proven wrong-doer on an exchange board "could diminish public confidence" in that exchange. 54 Fed. Reg. 37001 (Sept. 6, 1989). It also would make meaningless the "public interest" test all approved exchanges are statutorily required to meet. CEA §5(7).

The Cantor Exchange thus presents a fundamental legal issue. Should disciplined firms be allowed to appoint a majority of an exchange's board? If the answer is yes, it would represent Commission-endorsed permissiveness for wrong-doing which is wholly incompatible with the course Congress has directed the Commission to follow, and which the Commission has followed, in recent years. If the answer is no, as it should be, then the Commission must tell the Cantor Exchange to withdraw its application and wait for the three year period in Rule 1.63 to run. The Commission should answer "no" immediately and end its consideration of the Cantor Exchange's legally flawed application.

History of Section 5a(a)(16) of the CEA and CFTC Rule 1.63

In the summer of 1989, the House Agriculture Committee reported out favorably a bill, H.R. 2869, to improve futures regulation. Among other provisions, Section 204 of that bill required the Commission to issue regulations to disqualify any individual member of an exchange that had been found to have committed any major violation from service on the governing board or disciplinary committee of any contract market for a period of time to be determined by the Commission. H. R. Rep. No. 101-236, supra, at 6, 27. On September 6, 1989, the Commission wrote the Committee in support of the provision and advised the Committee "we are already undertaking a rule-making in this area." Id. at 50.

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[1] Hearings on S.207, the Futures Trading Practices Act of 1991, Before the Senate Committee on Agriculture, Nutrition and Forestry, 102d Cong. 1st Sess. 27 (1991) (Enclosure to Letter from CFTC Chairman Gramm to Senator Patrick J. Leahy).

That same day, the Commission did propose and ask for public comments on Rule 1.63. The rationale was explained by the Commission at that time as follows:

> "The probity of the self-regulatory process requires that SRO bodies which establish and enforce an SRO's rules be impartial and free from the potential for and even the appearance of impropriety. The Commission further believes that the actual and perceived integrity with which an SRO operates is largely determined by the character and experience of the persons who serve on the SRO's rule-making and rule-enforcing bodies. The Commission is concerned, for instance, that a person found to have acted ... dishonestly ... may be or may be perceived to be unwilling to formulate or enforce an SRO's rules in a fully principled manner. The Commission also believes that the presence of such a person on a . . . governing board could diminish public confidence in that SRO as a self-regulator of its respective marketplace."

54 Fed. Reg. 37001 (Sept. 6, 1989). In summary, the Commission proposed Rule 1.63 due to its belief "that the integrity of the self-regulatory process requires that SRO bodies which make and enforce an SRO's rules be impartial and free from the potential for even the appearance of impropriety." Id. at 37001-37002.

For other reasons, Congress did not enact the statutory disqualification provisions for exchange boards until 1992. See CEA § 5a(a)(16); Section 206(a)(1) of the Futures Trading Practices Act of 1992, H.R. Rep. No 102-978, 102d Cong. 2d Sess. 58-59 (1992). In the interim, however, the Commission adopted Rule 1.63, specifically rejecting arguments that the 3 year ban should not apply to persons that were the subject of discipline resulting from settlements rather than full adjudications. 55 Fed. Reg. 7884, 7887 (March 6, 1990). Thus, since 1990 CFTC Rule 1.63 has required contract markets to have rules making all members with disciplinary histories ineligible to serve on exchange boards and committees.

Even though Rule 1.63 was then on the books, Congress decided to underscore the policies and protections it embodied by enacting new section 5a(a)(16) of the CEA. The Senate Committee on Agriculture, Nutrition and Forestry proposed that provision to require that exchange "members having violated Federal commodity law or other rules reflecting on their fitness be barred from serving on exchange oversight or disciplinary panels for an appropriate time as defined by the Commission." S. Rep. No. 102-22, 102d Cong., 1st. Sess. 13 (1991). The Commission commented in support of the largely parallel provision in the then pending House bill claiming that Rule 1.63 "fully implemented" the proposed legislation "and, in some respects, [is] broader in [its] application." H. R. Rep. No. 102-6, supra, at 55. With virtually no opposition, therefore, Congress enacted CEA § 5a(a)(16) to require each contract market to

> "Provide that no member found by the Commission, a contract market, a registered futures association, or a court of competent jurisdiction to have committed any violation of this Act or any other provision of law that would reflect on the fitness of the member may serve on any contract market oversight or disciplinary panel for an appropriate period (as defined by Commission rule)."

What CFTC Rule 1.63 Actually Says

CFTC Rule 1.63(b) provides that "[e]ach self-regulatory organization must maintain in effect rules ... that render a person ineligible to serve on its ... governing board who: ... (2) Entered into a settlement agreement within the prior three years in which any of the findings or, in the absence of findings, any of the acts charged included a disciplinary offense." The term "disciplinary offense" is defined to mean "any violation of the Act." (CFTC Rule 1.63(a)(6)(iii)). The term "settlement agreement" is defined to mean "any agreement consenting to the imposition of sanctions by . . . the Commission." (CFTC Rule 1.63 (a)(7)). The term self-regulatory organization includes "contract market". (CFTC Rule 1.3(ee)). The term "person" is defined to "include[] individuals, associations, partnerships, corporations, and trusts." (CFTC Rule 1.3(u)).

In addition to imposing a duty on a contract market, as called for by CEA § 5a(a)(16), CFTC Rule 1.63(c) goes further. It states:

> "No person may serve on a ... governing board of any self-regulatory organization if such person is subject to any of the conditions listed in paragraphs (b)(1) through (6) of this section."

Thus, Commission rules prohibit any person from serving on a board of directors of any exchange for a three year period after such person has entered into a settlement with the Commission imposing sanctions for violations of any provision of the Act.

Did Cantor Fitzgerald Inc. Commit a Disciplinary Offense Under Rule 1.63?

On January 28, 1997, the Commission entered into a settlement with Cantor Fitzgerald. In the Matter of Jerry W. Slusser, et al, CFTC Docket No. 94-14 (Settlement Order Against Cantor Fitzgerald, Inc.). In that settlement order, Cantor consented to Commission findings of aiding and abetting statutory violations of the registration and antifraud requirements for commodity pool operators, CEA §§4m(1) and 4o(1)(B). Cantor was ordered by the CFTC to cease and desist such violations, to pay a $500,000 fine and to comply with numerous undertakings.

Indisputably, Cantor committed a disciplinary offense under and is subject to the ban in CFTC Rule 1.63. It entered into a settlement with the Commission which resulted in findings of violations of the Act and the imposition of sanctions. Cantor also is a person under CFTC Rule 1.63 since it is a corporation, falling within the express definition in CFTC Rule 1.3(u). For three years, therefore, Cantor may not serve on an exchange board.

Ironically, as drafted, the proposed Cantor Exchange's Rule 501 adheres to CFTC Rule 1.63 by prohibiting "any person" that committed a Disciplinary Offense (as defined in CFTC Rule 1.63) within 3 years from serving on the "Exchange Governing Board" of the Cantor Exchange. Thus, Cantor would be disqualified from serving on its own exchange's board under the very rules it has proposed. Yet Section 1 of the Cantor Exchange's By-Laws Confirm that Cantor willl appoint 8 of the 13 members of the new Exchange's Board of Directors. Cantor has made no effort to reconcile this basic inconsistency in its own rules. Nor could it do so.

Does the Ban on Serving on an Exchange Board Apply to Appointing a Majority of Those Who Will Serve On An Exchange's Board?

At the time Congress passed CEA § 5a(a)(16) and the Commission adopted Rule 1.63, no proprietary exchange existed or was even contemplated. (In fact, a separate and independent legal deficiency in the Cantor Exchange application is that no exchange may be controlled by a proprietary firm. That is, futures exchanges must be controlled by their members.) It is not surprising, therefore, that both provisions speak in terms of serving on an exchange board, rather than appointing the members who will control the exchange's board.

But that makes little difference. The power to appoint someone to an exchange board is functionally equivalent to the power to serve on an exchange board. That is especially true where, as here, the proven wrong-doer would be selecting 8 out of 13 members of an exchange's board. As the Commission noted in adopting Rule 1.63, "The purpose of Regulation 1.63 is that SRO's should not allow violators to make rules or sit in judgment of other rule violators." 55 Fed. Reg. at 7884. On the Cantor Exchange, Cantor will "make rules" through its selected board even more readily than if it was just a single member of an exchange's board. For that reason, the Cantor Exchange would not comply with CEA § 5a(a)(16) or CFTC Rule 1.63 and would not comply "in all respects" with the requirements for a board of trade seeking contract market designation as required by CEA § 5(6). Its application should be denied.

Even if none of those points was persuasive, the statute still requires that the Cantor Exchange demonstrate that its designation as a contract market would not be contrary to the public interest. CEA § 5(7). In other words, even if appointing a majority of an exchange board is not violative of CFTC Rule 1.63, the Cantor Exchange must still clear the public interest hurdle. If the public interest means anything, it should mean that "proven wrong-doers" should not control an exchange's board. Otherwise

the public interests Congress identified in enacting CEA § 5a(a)(16) and the Commission identified in adopting CFTC Rule 1.63 would be seriously eroded. Allowing the Cantor firm, a proven wrong-doer, to control the Cantor Exchange would, at a minimum, "diminish public confidence" in the ability of the Exchange to police its markets. Cf. 55 Fed. Reg. 7884. The Commission simply can not make the required public interest finding for the Cantor Exchange.

Upon becoming Chairperson, Brooksley Born stated

> "we have a statutory obligation to enforce the law. We have the most admired regulatory system in the world in part because of our willingness to enforce our laws vigorously. I plan to continue the Commission's strong commitment to its enforcement program."[2]

The Cantor Exchange application constitutes a serious challenge to the Commission's "willingness to enforce our laws vigorously." Allowing the Cantor Exchange to skirt statutory and regulatory requirements would not be vigorous enforcement of the law. Federal law flatly bars persons who the Commission has disciplined from being part of exchange self-regulatory management. The Cantor firm has been so disciplined and should not be allowed to control an exchange. The choice is the Commission's. The answer should be easy.

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[2] Remarks of Brooksley Born, Chairperson, Commodity Futures Trading Commission at the Chicago Kent-ITT Commodities Law Institute, Chicago, Illinois (Oct. 24, 1996).

ISSUE #2

IS IT CONTRARY TO THE PUBLIC INTEREST, INCLUDING THE PUBLIC INTEREST TO BE PROTECTED BY THE ANTITRUST LAWS, FOR AN EXCHANGE TO BAR ALL FLOOR BROKERS, EXCEPT THE EMPLOYEES OF A SINGLE FIRM, FROM ACTING AS FLOOR BROKERS ON THE EXCHANGE?

FLOOR BROKERAGE MONOPOLY VIOLATES
CEA § 15 AND THE PUBLIC INTEREST

1. According to the National Futures Association, the New York Cotton Exchange currently has 476 registered floor brokers and the Coffee, Sugar and Cocoa Exchange has 561 registered floor brokers. To the extent those floor brokers are full members of either of those exchanges, those floor brokers could become a Class B members of the Cantor Exchange by paying $100 thereby allowing those persons to become "Authorized Traders" on the Cantor Exchange.

2. But none of those 1037 registered floor brokers are eligible to be floor brokers on the Cantor Exchange. The only floor brokers on the Cantor Exchange are "Terminal Operators," defined, by exchange rule, to be "an employee of Cantor Fitzgerald Securities who is authorized by Cantor and CFFE to accept orders for Contracts and to enter such orders into the Cantor System." CFFE Rule 31

3. By excluding those 1037 registered floor brokers from acting as floor brokers on the CFFE, the Cantor Exchange has erected the most extreme form of barrier to entry to the floor brokerage business, a monopoly.

4. In the past, the CFTC has denied other exchange-proposed "barriers to entry" that fell far short of the kind of floor brokerage monopoly the Cantor Exchange envisions. For example, just last year, the CFTC denied a Chicago Board of Trade proposal to impose a $40 million net capital requirement on the issuers of shipping certificates for its grain contracts. Although the CFTC conceded the proposed net capital rule served an important public interest in promoting financial integrity, the Commission found the proposal to violate CEA § 15 since it would have reduced the number of firms eligible to issue certificates from 7 to 4, or what the CFTC called "an extremely high level of concentration." 62 Fed. Reg. at 60853. As a result, the Commission rejected the Board of Trade's proposal as an unjustified barrier to entry that was violative of the public interests served by the antitrust laws without any countervailing regulatory justification.

5. The Cantor Exchange, of course, proposes to do more than reduce 7 firms to 4. Its proposal would bar over a thousand registered floor brokers from acting as floor brokers on the Cantor Exchange and replace them with the employees of a single firm that has been granted a floor brokerage monopoly. Replacing competitive floor brokerage with a monopoly is irreconcilable with past CFTC precedent under CEA § 15.

ISSUE #3

IS IT CONTRARY TO THE PUBLIC INTEREST, INCLUDING THE PUBLIC INTEREST TO BE PROTECTED BY THE ANTITRUST LAWS, FOR A NEW EXCHANGE TO SET FLOOR BROKERAGE COMMISSION RATES ON THE EXCHANGE (CALLED TRANSACTION FEES) WHEN THE ANTITRUST LAWS BAR ALL OTHER EXCHANGES FROM SETTING, EVEN INDIRECTLY, BROKERAGE COMMISSIONS?

PRICE FIXING OF BROKERAGE COMMISSIONS;
ANOTHER CANTOR EXCHANGE ANTITRUST VIOLATION

1. Until the early 1970's, many exchanges imposed fixed brokerage commissions on their customers. At that time, the Justice Department concluded that floor brokerage rates and other commissions should be established competitively. To that end, the Department filed antitrust actions resulting in settlements that to this day enjoin exchanges from "directly or indirectly, fixing establishing, determining, recommending, suggesting, or adhering to any member or non-member commission rate or floor brokerage rate for commodity transactions . . . ." See 1974 Consent Decree.

2. The Commission has, from time to time, invoked the letter and spirit of that Consent Decree to ensure that exchanges provide for "freely competitive commissions and floor brokerage rates." (48 Fed. Reg. at 3399 (Jan. 25, 1983) (proposed disapproval of proposed CBOT rules on salaried brokers)). According to the Commission, an exchange that fixes commission rates would violate CEA § 15 and would be acting "contrary to the public interest."

3. The Cantor Exchange provides for "transaction fees" (CFFE Rule 32-A), defined to be the "fee determined in accordance with Rule 303-B for transacting a trade on the Cantor System." (Rule 303-B says that the aggressor who hits a bid or lifts an offer normally pays the transaction fee.) As Cantor's CEO Howard Lutnick testified in court, the transaction fee compensates the floor brokers, called Terminal Operators, on the Cantor Exchange for executing transactions:

> "Cantor Fitzgerald through a subsidiary has a contract with CFFE to provide the technology for them and to operate the system for them and use our brokers as terminal operators and register our brokers and **they will receive a fee per transaction.**"

Del Tr. 375:16-21 (emphasis added). Moreover, the Cantor Response to CFTC staff of May 6 confirms that "transaction fees" are one of two forms of compensation Cantor will receive.

4. Transaction fees are either set by the Cantor Exchange or by the Cantor Group which controls the Exchange. In either event, the transaction fees constitute fixed floor brokerage commissions, rather than competitively set commissions as the antitrust laws require. No other exchange would be allowed by the CFTC or the Justice Department to fix brokerage commissions. The Cantor Exchange should not receive special favored treatment.

ISSUE #4

DOES IT VIOLATE CEA §§ 4(a) AND 5(6) FOR AN EXCHANGE TO PROPOSE THAT NONE OF THE TRANSACTIONS ON ITS NEW CONTRACT MARKET WOULD "BE EXECUTED OR CONSUMMATED BY A MEMBER OF SUCH CONTRACT MARKET" THEREBY CIRCUMVENTING THE CEA'S SELF-REGULATORY FRAMEWORK?

[Note: CEA § 4(a) requires that all futures contracts must be conducted on or subject to the rules of a contract market and must be "executed or consummated by or through a member of such contract market." CEA § 5(6) requires that the governing board of a board of trade applying for contract market designation must provide "for compliance in all . . . respects with the requirements applicable to such board of trade under this Act."]

THE CANTOR EXCHANGE VIOLATES THE STATUTORY MANDATE ALLOWING ONLY MEMBERS TO EXECUTE TRADES

1. The Commodity Exchange Act requires all futures contracts to be traded on a contract market and "to be executed or consummated by or through a member of such contract market." CEA § 4(a). The statute further defines a "member of a contract market" to be "an individual, association, partnership, corporation, or trust owning or holding membership in, or admitted to membership representation on, a contract market or given members' trading privileges thereon." CEA § 1a(15).

2. All trades on the Cantor Exchange will be "executed or consummated" by Terminal Operators. Terminal Operators will be those employees of Cantor Fitzgerald Securities authorized by Cantor and CFFE to accept orders and to enter such orders into the Cantor system. Terminal Operators will not be members of the Cantor Exchange.

3. The Cantor Exchange has contracted out the order execution function to the Cantor firm and its employees, the Terminal Operators. By this mechanism, the Cantor Exchange is proposing to violate CEA § 4(a) since it would grant only non-members, the Terminal Operators, the ability to execute transactions on the Exchange. That violation disqualifies the Cantor Exchange from eligibility for contract market designation since the Exchange would not comply with all applicable statutory requirements. CEA § 5(6). The only mechanism available to the Cantor Exchange to correct this deficiency would be a Commission exemption granted under CEA § 4(c). The Cantor Exchange has not sought such an exemption to date.

4. Even if an exemption is sought, it should be denied. The Cantor Exchange is based upon inherent conflicts of interest and regulatory gaps which are incompatible with the public interest. No exchange could assure a fair and honest market if it is controlled by a firm that has a monopoly on order execution and hopes to profit from its market dominance in an integrated cash and futures market. Since the Terminal Operator will not be members of the Cantor Exchange, they will not be subject to any meaningful form or self-regulation futures markets customarily provide. See attached chart.

ABSENCE OF MEANINGFUL REGULATORY OVERSIGHT OF TERMINAL OPERATORS ON THE CANTOR EXCHANGE

The Terminal Operators, ***200 to 300 in number***, are the only persons who can execute customer orders on the Cantor Exchange. They may also solicit futures orders from customers. The Terminal Operators will operate in a closed, back room trading environment provided by their employer, the Cantor Group, where they will be free to have extensive communications with customers and with one another.

Yet, what regulatory oversight will apply to the Terminal Operators? Under the proprietary exchange structure that the Cantor Exchange and its sponsors are proposing, virtually none. The Terminal Operators are not members of the Cantor Exchange and, thus will evade the same regulatory scrutiny that applies to all other floor brokers and associated persons, as the following comparison confirms.

Under the Cantor Exchange Proposal	On All Other U.S. Exchanges
1. Exchange Oversight	1. Exchange Oversight
No compliance or disciplinary jurisdiction over Terminal Operators, who are not members of the Cantor Exchange, in violation of CEA § 4(a)(2).	***Required jurisdiction over members;*** this basic tenet of futures regulation is embodied in CEA §§ 4(a)(2), 5a(8) and 8(c).
No CFTC-approved procedural rules on how (if at all) Terminal Operators will be disciplined or by whom.	***Required disciplinary procedures set out in CFTC-approved rules***; these exchange rule must conform to CFTC requirements on due process and investigative fact finding, charges and hearing procedures
Deficient conduct rules for Terminal Operators; the Cantor Exchange is missing many rules that other exchanges are required to adopt. In any event, the Cantor Exchange would not be obligated to enforce its sparse Terminal Operator rules under the proprietary exchange structure it proposes.	***Required rules in many areas***, including trade practices, audit trail, record keeping, accountability of trade records, ethics training, sales practices, and broker associations, which the Cantor Exchange is missing for Terminal Operators.
Deficient surveillance programs including audit trail to detect potential rule violations by the Terminal Operators. In any event, the Cantor Exchange would not be obligated to enforce its sparse Terminal Operator rules under the proprietary exchange structure it proposes.	***Required to maintain effective surveillance programs***, including trade monitoring programs which must meet strict audit trail requirements to ensure the detection of trading abuses.

No CFTC reporting of any private disciplinary actions that may be taken against the Terminal Operators (by whomever), circumventing effective CFTC oversight of adequacy of such actions.

Must provide CFTC notice of disciplinary actions. Sanctions are subject to review either upon appeal or the CFTC's own initiative. CFTC has in the past required exchanges to increase penalties it believed inadequate. Disciplinary sanctions may also form the basis for denial or conditioning of floor broker registration.

No public posting of any private disciplinary actions that may be taken against Terminal Operators (by whomever), shielding such actions from customers.

Must post notice of disciplinary actions, including identity of the party, the nature of the violation, and the penalty imposed; must also notify NFA, which maintains a public data base on exchange disciplinary actions.

2. <u>CFTC Oversight</u>

Effective CFTC oversight is in serious question; existing legal framework does not fit:

- No CEA provisions or CFTC rules exist which set out a proprietary exchange's responsibilities to detect, deter and punish misconduct by its "non-member agents" who perform floor brokerage functions and solicit customer futures orders.

- No CEA provisions or CFTC rules exist which apply directly to trading or to customer communications by a proprietary exchange's "non-member agents" who perform floor brokerage functions and solicit customer futures orders.

- No CEA provisions or CFTC rules exist which provide a framework for how the CFTC should perform oversight of a proprietary exchange's self-regulatory activities.

No meaningful "rule enforcement" oversight -- what would the CFTC even look for in a rule enforcement review, when the Cantor Exchange has no legal obligation under its

2. <u>CFTC Oversight</u>

Extensive. Exchanges and exchange members operate in a closely supervised regulatory environment.

<u>Exchanges</u>

The CFTC conducts periodic rule enforcement reviews of exchanges. CFTC staff also closely examines the audit trail compliance of exchanges, but inexplicably has yet to apply the same standards or scrutiny to the Cantor Exchange.

<u>Members</u>

Exchange members are subject to numerous rules that the Terminal Operators will circumvent through form over substance of not being members of the Cantor Exchange.

Exchange members may separately be disciplined by the Commission for conduct addressed by exchange proceedings.

Exchange members can face denial or conditioning of floor broker and floor trader registration based on exchange proceedings.

Terminal Operators, however, avoid such serial sanctioning by the CFTC, because their

proposed structure to enforcement its rules against Terminal Operators through effective compliance and disciplinary programs?

3. <u>NFA Oversight</u>

None.

- NFA will not oversee the Terminal Operator's trade execution activities; NFA is not responsible for floor broker oversight because that responsibility is normally performed by the exchange on which a floor broker is a member.

- Terminal Operators will circumvent NFA sales practice rules and oversight because they are not registering as Associated Persons. (And since they are not members of the Cantor Exchange, they evade any sales practice requirements it imposes.)

- Similarly, their employer, Cantor Fitzgerald Securities, will also circumvent NFA sales practice rules and oversight, because the firm is not registering as a Futures Commission Merchant or Introducing Broker.

supervision and conduct is performed in secret.

3. <u>NFA Oversight</u>

Yes, over sales practices; N/A for trade execution.

- NFA oversight of floor brokers and floor traders is not necessary, because they are regulated by the exchange on which they are a member, unlike the Terminal Operators.

- Individuals who solicit futures business must work for a CFTC registered firm, join NFA as an associate member and register as an Associated Person; as NFA associate members, they are subject to NFA sales practice rules and oversight.

- Firms that solicit customer futures business must join NFA and register as a Futures Commission Merchant or an Introducing Broker; as NFA members, they are subject to NFA sales practice rules and oversight.

The exchanges also oversee the sales practice activities of their individual members and member firms.

ISSUE #5

IS IT CONTRARY TO THE PUBLIC INTEREST AND THE "OPEN AND COMPETITIVE" EXECUTION REQUIREMENT OF CFTC RULE 1.38, FOR A CONTRACT MARKET TO BE DESIGNED TO ALLOW TRADERS TO EXECUTE TRANSACTIONS "EVEN IF A BID OR OFFER SUPERIOR TO SUCH TRADER'S BID OR OFFER WOULD OTHERWISE BE AVAILABLE" (CFFE RULE 303 (b)(1))?

THE CANTOR EXCHANGE VIOLATES THE "OPEN AND COMPETITIVE" TRADING REQUIREMENT.

1. The Cantor Exchange will regularly allow non-competitive trading. In its simplest form, that non-competitive trading would occur in what is called "exclusive time" after any trade is made when the two parties to the trade may disregard all other bids and offers and negotiate larger quantities for their transaction at the original price. This practice encourages a form of block trading. It also means that a trader will be locked into a trade "even if a bid or offer superior to such trader's bid or offer would otherwise be available." CFFE Rule 303(b)(1). In addition, other types of non-competitive trades are allowed under the Cantor Exchange proposal. In the market crossing session, for instance, which is the only opportunity for customers to trade a smaller unit than the proposed $1 million minimum, the assigned match price "may be inferior to the prices that could otherwise be obtained," according to the Cantor Exchange's proposed disclosure statement submitted in June.

2. The block trading authorization is important as a matter of process and fairness. The Commission last spring extended the public comment period on a concept release designed to review whether block trading should be permitted on exchanges. The Cantor Exchange application jumps the gun on that rule making proceeding by seeking authorization to offer a block trading facility in contracts that are replicas of those traded on the Chicago Board of Trade where block trading is not allowed. If the Cantor Exchange insists on retaining its block trading-exclusive time rules, the Commission should defer approval of them until the Commission has taken final action on the block trading issues raised by its outstanding concept release.

3. In any event, the Cantor Exchange's non-competitive trading practices violate CFTC Rule 1.38. That rule requires that all executions of futures contracts must be done "openly and competitively." Nothing in that rule or its history has ever tolerated regular trading practices designed to freeze the bulk of market participants out of a market for a period of time while allowing trades routinely to be executed at prices other than the best price available. Indeed, years ago, members of Chicago exchanges were accused and convicted of criminal misconduct by foreclosing their customers from possibly getting the best price available. As the Seventh Circuit recognized, a broker's "deliberate refusal to pursue the best price the broker could obtain can constitute a scheme to defraud." U.S. v. Ashman, 979 F.2d 469, 478 (7th Cir. 1992). By design, the Cantor Exchange also refuses to allow its customers to receive the best prices available through trading practices that violate the longstanding open and competitive trading requirement. Unless changed, these trading practices are yet another legal deficiency in the Cantor Exchange application.

ISSUE #6

WOULD ALLOWING A NEW EXCHANGE TO ENGAGE IN ROUTINE NON-COMPETITIVE TRADING PRACTICES FOR U.S. TREASURY SECURITY FUTURES CONTRACTS THAT ARE LARGELY IDENTICAL TO CONTRACTS ALREADY COMPETITIVELY TRADED ON A LIQUID BASIS ON ANOTHER EXCHANGE CAUSE

- **PRICING DISTORTIONS;**
- **MARKET ILLIQUIDITY;**
- **WIDER BID-ASK SPREADS;**
- **INEFFICIENT HEDGING; AND**
- **INCREASED COST TO THE TREASURY (AND TAXPAYERS) FOR FINANCING U.S. DEBT?**

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ISSUE #1

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THE CANTOR EXCHANGE VIOLATES
THE FITNESS REQUIREMENTS OF FEDERAL LAW.

Federal law prohibits any person that has committed a disciplinary offense from serving on the board of directors of a futures exchange for three years. The Commodity Futures Trading Commission found Cantor Fitzgerald & Co. to have committed a disciplinary offense in January 1997. But the Cantor firm now has applied to the CFTC to appoint a majority (8 out of 13) of the members of the Board of Directors of the proposed new Cantor Financial Futures Exchange. **Allowing Cantor to control the proposed exchange's board on which it would not even be eligible to serve would make a sham of the three year ban and the statute's "public interest" test.** Yet the CFTC has turned a deaf ear to that concern and instead appears ready to approve the Cantor Exchange application this summer. That approval would eviscerate the fitness requirements for exchange boards that Congress and the CFTC adopted so recently. The Commission should enforce the law consistent with the public interest and deny the Cantor Exchange's application.

Background and Summary

Like other corporations, futures exchanges are run by boards of directors. In 1989, the House Agriculture Committee heard "complaints that service on the governing boards of . . . contract markets and self-regulatory organizations by proven wrong-doers creates, at best, an image of leniency in the regulation of the markets." H.R. Rep. No. 101-236, 101 Cong. 1st Sess. 19 (1989). *See also* H.R. Rep. No. 102-6, 101st Cong. 2d Sess. 23 (1991). To remove that concern, Congress and the CFTC have combined to adopt a simple rule "to ensure the protection of the public and fairness to persons in the industry." Id. That rule is now codified in CFTC Rule 1.63 and provides -- *any person subject to a disciplinary offense -- a "proven wrong-doer" to use the House Committee's words -- is disqualified from serving as a member of an exchange's board of directors for a three year period.* That three year ban is hard and fast. No exceptions have been allowed. Until now.

The proposed Cantor Financial Futures Exchange is purposefully designed to skirt Rule 1.63. Last year, Cantor Fitzgerald & Co. was found by the CFTC to have aided and abetted a fraudulent scheme, fined $500,000, and ordered to cease and desist violating the Act's antifraud provisions. Despite this undisputed disciplinary offense, Cantor asserts it may now appoint 8 of the 13 members of the board of directors of the Cantor Exchange. In other words, although the Cantor firm is a "proven wrong doer" and could not serve on any exchange's board until the year 2000, Cantor is asking the CFTC to approve an application that would allow Cantor to control its new Exchange by appointing a majority of the Exchange's board of directors.

What does the CFTC say to this? Nothing. In the six months since the Cantor Exchange application was filed, the Commission has seemingly embraced the Cantor Exchange's mockery of Rule 1.63, a rule the CFTC told Congress in 1991

"enhances the actual and perceived integrity of the SRO's."[1] Despite written public comments raising the Rule 1.63 deficiency, the Commission has never once asked the Cantor Exchange for even a justification of its disregard of that Rule. Nor has the Commission indicated in any of its requests for comments on the new exchange that Rule 1.63 even poses a material issue.

The Commission's lack of concern is hard to explain. No one could seriously maintain that an individual "proven wrong-doer"serving on an exchange's board creates an intolerable perception of impropriety but allowing a firm that is a "proven wrong doer" to appoint a controlling majority of an exchange's board creates no perception of impropriety. That kind of form over substance makes a mockery of Rule 1.63, a rule the CFTC adopted, in its own words, to preserve the "actual and perceived integrity" of exchanges since the mere presence of a single proven wrong-doer on an exchange board "could diminish public confidence" in that exchange. 54 Fed. Reg. 37001 (Sept. 6, 1989). It also would make meaningless the "public interest" test all approved exchanges are statutorily required to meet. CEA §5(7).

The Cantor Exchange thus presents a fundamental legal issue. Should disciplined firms be allowed to appoint a majority of an exchange's board? If the answer is yes, it would represent Commission-endorsed permissiveness for wrong-doing which is wholly incompatible with the course Congress has directed the Commission to follow, and which the Commission has followed, in recent years. If the answer is no, as it should be, then the Commission must tell the Cantor Exchange to withdraw its application and wait for the three year period in Rule 1.63 to run. The Commission should answer "no" immediately and end its consideration of the Cantor Exchange's legally flawed application.

History of Section 5a(a)(16) of the CEA and CFTC Rule 1.63

In the summer of 1989, the House Agriculture Committee reported out favorably a bill, H.R. 2869, to improve futures regulation. Among other provisions, Section 204 of that bill required the Commission to issue regulations to disqualify any individual member of an exchange that had been found to have committed any major violation from service on the governing board or disciplinary committee of any contract market for a period of time to be determined by the Commission. H. R. Rep. No. 101-236, supra, at 6, 27. On September 6, 1989, the Commission wrote the Committee in support of the provision and advised the Committee "we are already undertaking a rule-making in this area." Id. at 50.

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[1] Hearings on S.207, the Futures Trading Practices Act of 1991, Before the Senate Committee on Agriculture, Nutrition and Forestry, 102d Cong. 1st Sess. 27 (1991) (Enclosure to Letter from CFTC Chairman Gramm to Senator Patrick J. Leahy).

That same day, the Commission did propose and ask for public comments on Rule 1.63. The rationale was explained by the Commission at that time as follows:

> "The probity of the self-regulatory process requires that SRO bodies which establish and enforce an SRO's rules be impartial and free from the potential for and even the appearance of impropriety. The Commission further believes that the actual and perceived integrity with which an SRO operates is largely determined by the character and experience of the persons who serve on the SRO's rule-making and rule-enforcing bodies. The Commission is concerned, for instance, that a person found to have acted ... dishonestly ... may be or may be perceived to be unwilling to formulate or enforce an SRO's rules in a fully principled manner. The Commission also believes that the presence of such a person on a . . . governing board could diminish public confidence in that SRO as a self-regulator of its respective marketplace."

54 Fed. Reg. 37001 (Sept. 6, 1989). In summary, the Commission proposed Rule 1.63 due to its belief "that the integrity of the self-regulatory process requires that SRO bodies which make and enforce an SRO's rules be impartial and free from the potential for even the appearance of impropriety." Id. at 37001-37002.

For other reasons, Congress did not enact the statutory disqualification provisions for exchange boards until 1992. See CEA § 5a(a)(16); Section 206(a)(1) of the Futures Trading Practices Act of 1992, H.R. Rep. No 102-978, 102d Cong. 2d Sess. 58-59 (1992). In the interim, however, the Commission adopted Rule 1.63, specifically rejecting arguments that the 3 year ban should not apply to persons that were the subject of discipline resulting from settlements rather than full adjudications. 55 Fed. Reg. 7884, 7887 (March 6, 1990). Thus, since 1990 CFTC Rule 1.63 has required contract markets to have rules making all members with disciplinary histories ineligible to serve on exchange boards and committees.

Even though Rule 1.63 was then on the books, Congress decided to underscore the policies and protections it embodied by enacting new section 5a(a)(16) of the CEA. The Senate Committee on Agriculture, Nutrition and Forestry proposed that provision to require that exchange "members having violated Federal commodity law or other rules reflecting on their fitness be barred from serving on exchange oversight or disciplinary panels for an appropriate time as defined by the Commission." S. Rep. No. 102-22, 102d Cong., 1st. Sess. 13 (1991). The Commission commented in support of the largely parallel provision in the then pending House bill claiming that Rule 1.63 "fully implemented" the proposed legislation "and, in some respects, [is] broader in [its] application." H. R. Rep. No. 102-6, supra, at 55. With virtually no opposition, therefore, Congress enacted CEA § 5a(a)(16) to require each contract market to

> "Provide that no member found by the Commission, a contract market, a registered futures association, or a court of competent jurisdiction to have committed any violation of this Act or any other provision of law that would reflect on the fitness of the member may serve on any contract market oversight or disciplinary panel for an appropriate period (as defined by Commission rule)."

What CFTC Rule 1.63 Actually Says

CFTC Rule 1.63(b) provides that "[e]ach self-regulatory organization must maintain in effect rules ... that render a person ineligible to serve on its ... governing board who: ... (2) Entered into a settlement agreement within the prior three years in which any of the findings or, in the absence of findings, any of the acts charged included a disciplinary offense." The term "disciplinary offense" is defined to mean "any violation of the Act." (CFTC Rule 1.63(a)(6)(iii)). The term "settlement agreement" is defined to mean "any agreement consenting to the imposition of sanctions by . . . the Commission." (CFTC Rule 1.63 (a)(7)). The term self-regulatory organization includes "contract market". (CFTC Rule 1.3(ee)). The term "person" is defined to "include[] individuals, associations, partnerships, corporations, and trusts." (CFTC Rule 1.3(u)).

In addition to imposing a duty on a contract market, as called for by CEA § 5a(a)(16), CFTC Rule 1.63(c) goes further. It states:

> "No person may serve on a ... governing board of any self-regulatory organization if such person is subject to any of the conditions listed in paragraphs (b)(1) through (6) of this section."

Thus, Commission rules prohibit any person from serving on a board of directors of any exchange for a three year period after such person has entered into a settlement with the Commission imposing sanctions for violations of any provision of the Act.

Did Cantor Fitzgerald Inc. Commit a Disciplinary Offense Under Rule 1.63?

On January 28, 1997, the Commission entered into a settlement with Cantor Fitzgerald. In the Matter of Jerry W. Slusser, et al, CFTC Docket No. 94-14 (Settlement Order Against Cantor Fitzgerald, Inc.). In that settlement order, Cantor consented to Commission findings of aiding and abetting statutory violations of the registration and antifraud requirements for commodity pool operators, CEA §§4m(1) and 4o(1)(B). Cantor was ordered by the CFTC to cease and desist such violations, to pay a $500,000 fine and to comply with numerous undertakings.

Indisputably, Cantor committed a disciplinary offense under and is subject to the ban in CFTC Rule 1.63. It entered into a settlement with the Commission which resulted in findings of violations of the Act and the imposition of sanctions. Cantor also is a person under CFTC Rule 1.63 since it is a corporation, falling within the express definition in CFTC Rule 1.3(u). For three years, therefore, Cantor may not serve on an exchange board.

Ironically, as drafted, the proposed Cantor Exchange's Rule 501 adheres to CFTC Rule 1.63 by prohibiting "any person" that committed a Disciplinary Offense (as defined in CFTC Rule 1.63) within 3 years from serving on the "Exchange Governing Board" of the Cantor Exchange. Thus, Cantor would be disqualified from serving on its own exchange's board under the very rules it has proposed. Yet Section 1 of the Cantor Exchange's By-Laws Confirm that Cantor willl appoint 8 of the 13 members of the new Exchange's Board of Directors. Cantor has made no effort to reconcile this basic inconsistency in its own rules. Nor could it do so.

Does the Ban on Serving on an Exchange Board Apply to Appointing a Majority of Those Who Will Serve On An Exchange's Board?

At the time Congress passed CEA § 5a(a)(16) and the Commission adopted Rule 1.63, no proprietary exchange existed or was even contemplated. (In fact, a separate and independent legal deficiency in the Cantor Exchange application is that no exchange may be controlled by a proprietary firm. That is, futures exchanges must be controlled by their members.) It is not surprising, therefore, that both provisions speak in terms of serving on an exchange board, rather than appointing the members who will control the exchange's board.

But that makes little difference. The power to appoint someone to an exchange board is functionally equivalent to the power to serve on an exchange board. That is especially true where, as here, the proven wrong-doer would be selecting 8 out of 13 members of an exchange's board. As the Commission noted in adopting Rule 1.63, "The purpose of Regulation 1.63 is that SRO's should not allow violators to make rules or sit in judgment of other rule violators." 55 Fed. Reg. at 7884. On the Cantor Exchange, Cantor will "make rules" through its selected board even more readily than if it was just a single member of an exchange's board. For that reason, the Cantor Exchange would not comply with CEA § 5a(a)(16) or CFTC Rule 1.63 and would not comply "in all respects" with the requirements for a board of trade seeking contract market designation as required by CEA § 5(6). Its application should be denied.

Even if none of those points was persuasive, the statute still requires that the Cantor Exchange demonstrate that its designation as a contract market would not be contrary to the public interest. CEA § 5(7). In other words, even if appointing a majority of an exchange board is not violative of CFTC Rule 1.63, the Cantor Exchange must still clear the public interest hurdle. If the public interest means anything, it should mean that "proven wrong-doers" should not control an exchange's board. Otherwise

the public interests Congress identified in enacting CEA § 5a(a)(16) and the Commission identified in adopting CFTC Rule 1.63 would be seriously eroded. Allowing the Cantor firm, a proven wrong-doer, to control the Cantor Exchange would, at a minimum, "diminish public confidence" in the ability of the Exchange to police its markets. Cf. 55 Fed. Reg. 7884. The Commission simply can not make the required public interest finding for the Cantor Exchange.

Upon becoming Chairperson, Brooksley Born stated

> "we have a statutory obligation to enforce the law. We have the most admired regulatory system in the world in part because of our willingness to enforce our laws vigorously. I plan to continue the Commission's strong commitment to its enforcement program."[2]

The Cantor Exchange application constitutes a serious challenge to the Commission's "willingness to enforce our laws vigorously." Allowing the Cantor Exchange to skirt statutory and regulatory requirements would not be vigorous enforcement of the law. Federal law flatly bars persons who the Commission has disciplined from being part of exchange self-regulatory management. The Cantor firm has been so disciplined and should not be allowed to control an exchange. The choice is the Commission's. The answer should be easy.

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[2] Remarks of Brooksley Born, Chairperson, Commodity Futures Trading Commission at the Chicago Kent-ITT Commodities Law Institute, Chicago, Illinois (Oct. 24, 1996).

ISSUE #2

IS IT CONTRARY TO THE PUBLIC INTEREST, INCLUDING THE PUBLIC INTEREST TO BE PROTECTED BY THE ANTITRUST LAWS, FOR AN EXCHANGE TO BAR ALL FLOOR BROKERS, EXCEPT THE EMPLOYEES OF A SINGLE FIRM, FROM ACTING AS FLOOR BROKERS ON THE EXCHANGE?

FLOOR BROKERAGE MONOPOLY VIOLATES
CEA § 15 AND THE PUBLIC INTEREST

1. According to the National Futures Association, the New York Cotton Exchange currently has 476 registered floor brokers and the Coffee, Sugar and Cocoa Exchange has 561 registered floor brokers. To the extent those floor brokers are full members of either of those exchanges, those floor brokers could become a Class B members of the Cantor Exchange by paying $100 thereby allowing those persons to become "Authorized Traders" on the Cantor Exchange.

2. But none of those 1037 registered floor brokers are eligible to be floor brokers on the Cantor Exchange. The only floor brokers on the Cantor Exchange are "Terminal Operators," defined, by exchange rule, to be "an employee of Cantor Fitzgerald Securities who is authorized by Cantor and CFFE to accept orders for Contracts and to enter such orders into the Cantor System." CFFE Rule 31

3. By excluding those 1037 registered floor brokers from acting as floor brokers on the CFFE, the Cantor Exchange has erected the most extreme form of barrier to entry to the floor brokerage business, a monopoly.

4. In the past, the CFTC has denied other exchange-proposed "barriers to entry" that fell far short of the kind of floor brokerage monopoly the Cantor Exchange envisions. For example, just last year, the CFTC denied a Chicago Board of Trade proposal to impose a $40 million net capital requirement on the issuers of shipping certificates for its grain contracts. Although the CFTC conceded the proposed net capital rule served an important public interest in promoting financial integrity, the Commission found the proposal to violate CEA § 15 since it would have reduced the number of firms eligible to issue certificates from 7 to 4, or what the CFTC called "an extremely high level of concentration." 62 Fed. Reg. at 60853. As a result, the Commission rejected the Board of Trade's proposal as an unjustified barrier to entry that was violative of the public interests served by the antitrust laws without any countervailing regulatory justification.

5. The Cantor Exchange, of course, proposes to do more than reduce 7 firms to 4. Its proposal would bar over a thousand registered floor brokers from acting as floor brokers on the Cantor Exchange and replace them with the employees of a single firm that has been granted a floor brokerage monopoly. Replacing competitive floor brokerage with a monopoly is irreconcilable with past CFTC precedent under CEA § 15.

ISSUE #3

IS IT CONTRARY TO THE PUBLIC INTEREST, INCLUDING THE PUBLIC INTEREST TO BE PROTECTED BY THE ANTITRUST LAWS, FOR A NEW EXCHANGE TO SET FLOOR BROKERAGE COMMISSION RATES ON THE EXCHANGE (CALLED TRANSACTION FEES) WHEN THE ANTITRUST LAWS BAR ALL OTHER EXCHANGES FROM SETTING, EVEN INDIRECTLY, BROKERAGE COMMISSIONS?

PRICE FIXING OF BROKERAGE COMMISSIONS;
ANOTHER CANTOR EXCHANGE ANTITRUST VIOLATION

1. Until the early 1970's, many exchanges imposed fixed brokerage commissions on their customers. At that time, the Justice Department concluded that floor brokerage rates and other commissions should be established competitively. To that end, the Department filed antitrust actions resulting in settlements that to this day enjoin exchanges from "directly or indirectly, fixing establishing, determining, recommending, suggesting, or adhering to any member or non-member commission rate or floor brokerage rate for commodity transactions . . . ." See 1974 Consent Decree.

2. The Commission has, from time to time, invoked the letter and spirit of that Consent Decree to ensure that exchanges provide for "freely competitive commissions and floor brokerage rates." (48 Fed. Reg. at 3399 (Jan. 25, 1983) (proposed disapproval of proposed CBOT rules on salaried brokers)). According to the Commission, an exchange that fixes commission rates would violate CEA § 15 and would be acting "contrary to the public interest."

3. The Cantor Exchange provides for "transaction fees" (CFFE Rule 32-A), defined to be the "fee determined in accordance with Rule 303-B for transacting a trade on the Cantor System." (Rule 303-B says that the aggressor who hits a bid or lifts an offer normally pays the transaction fee.) As Cantor's CEO Howard Lutnick testified in court, the transaction fee compensates the floor brokers, called Terminal Operators, on the Cantor Exchange for executing transactions:

> "Cantor Fitzgerald through a subsidiary has a contract with CFFE to provide the technology for them and to operate the system for them and use our brokers as terminal operators and register our brokers and **they will receive a fee per transaction**."

Del Tr. 375:16-21 (emphasis added). Moreover, the Cantor Response to CFTC staff of May 6 confirms that "transaction fees" are one of two forms of compensation Cantor will receive.

4. Transaction fees are either set by the Cantor Exchange or by the Cantor Group which controls the Exchange. In either event, the transaction fees constitute fixed floor brokerage commissions, rather than competitively set commissions as the antitrust laws require. No other exchange would be allowed by the CFTC or the Justice Department to fix brokerage commissions. The Cantor Exchange should not receive special favored treatment.

ISSUE #4

DOES IT VIOLATE CEA §§ 4(a) AND 5(6) FOR AN EXCHANGE TO PROPOSE THAT NONE OF THE TRANSACTIONS ON ITS NEW CONTRACT MARKET WOULD "BE EXECUTED OR CONSUMMATED BY A MEMBER OF SUCH CONTRACT MARKET" THEREBY CIRCUMVENTING THE CEA'S SELF-REGULATORY FRAMEWORK?

[Note: CEA § 4(a) requires that all futures contracts must be conducted on or subject to the rules of a contract market and must be "executed or consummated by or through a member of such contract market." CEA § 5(6) requires that the governing board of a board of trade applying for contract market designation must provide "for compliance in all . . . respects with the requirements applicable to such board of trade under this Act."]

THE CANTOR EXCHANGE VIOLATES THE STATUTORY MANDATE ALLOWING ONLY MEMBERS TO EXECUTE TRADES

1. The Commodity Exchange Act requires all futures contracts to be traded on a contract market and "to be executed or consummated by or through a member of such contract market." CEA § 4(a). The statute further defines a "member of a contract market" to be "an individual, association, partnership, corporation, or trust owning or holding membership in, or admitted to membership representation on, a contract market or given members' trading privileges thereon." CEA § 1a(15).

2. All trades on the Cantor Exchange will be "executed or consummated" by Terminal Operators. Terminal Operators will be those employees of Cantor Fitzgerald Securities authorized by Cantor and CFFE to accept orders and to enter such orders into the Cantor system. Terminal Operators will not be members of the Cantor Exchange.

3. The Cantor Exchange has contracted out the order execution function to the Cantor firm and its employees, the Terminal Operators. By this mechanism, the Cantor Exchange is proposing to violate CEA § 4(a) since it would grant only non-members, the Terminal Operators, the ability to execute transactions on the Exchange. That violation disqualifies the Cantor Exchange from eligibility for contract market designation since the Exchange would not comply with all applicable statutory requirements. CEA § 5(6). The only mechanism available to the Cantor Exchange to correct this deficiency would be a Commission exemption granted under CEA § 4(c). The Cantor Exchange has not sought such an exemption to date.

4. Even if an exemption is sought, it should be denied. The Cantor Exchange is based upon inherent conflicts of interest and regulatory gaps which are incompatible with the public interest. No exchange could assure a fair and honest market if it is controlled by a firm that has a monopoly on order execution and hopes to profit from its market dominance in an integrated cash and futures market. Since the Terminal Operator will not be members of the Cantor Exchange, they will not be subject to any meaningful form or self-regulation futures markets customarily provide. See attached chart.

ABSENCE OF MEANINGFUL REGULATORY OVERSIGHT OF TERMINAL OPERATORS ON THE CANTOR EXCHANGE

The Terminal Operators, ***200 to 300 in number***, are the only persons who can execute customer orders on the Cantor Exchange. They may also solicit futures orders from customers. The Terminal Operators will operate in a closed, back room trading environment provided by their employer, the Cantor Group, where they will be free to have extensive communications with customers and with one another.

Yet, what regulatory oversight will apply to the Terminal Operators? Under the proprietary exchange structure that the Cantor Exchange and its sponsors are proposing, virtually none. The Terminal Operators are not members of the Cantor Exchange and, thus will evade the same regulatory scrutiny that applies to all other floor brokers and associated persons, as the following comparison confirms.

Under the Cantor Exchange Proposal	On All Other U.S. Exchanges
1. Exchange Oversight	1. Exchange Oversight
No compliance or disciplinary jurisdiction over Terminal Operators, who are not members of the Cantor Exchange, in violation of CEA § 4(a)(2).	***Required jurisdiction over members;*** this basic tenet of futures regulation is embodied in CEA §§ 4(a)(2), 5a(8) and 8(c).
No CFTC-approved procedural rules on how (if at all) Terminal Operators will be disciplined or by whom.	***Required disciplinary procedures set out in CFTC-approved rules***; these exchange rule must conform to CFTC requirements on due process and investigative fact finding, charges and hearing procedures
Deficient conduct rules for Terminal Operators; the Cantor Exchange is missing many rules that other exchanges are required to adopt. In any event, the Cantor Exchange would not be obligated to enforce its sparse Terminal Operator rules under the proprietary exchange structure it proposes.	***Required rules in many areas***, including trade practices, audit trail, record keeping, accountability of trade records, ethics training, sales practices, and broker associations, which the Cantor Exchange is missing for Terminal Operators.
Deficient surveillance programs including audit trail to detect potential rule violations by the Terminal Operators. In any event, the Cantor Exchange would not be obligated to enforce its sparse Terminal Operator rules under the proprietary exchange structure it proposes.	***Required to maintain effective surveillance programs***, including trade monitoring programs which must meet strict audit trail requirements to ensure the detection of trading abuses.

No CFTC reporting of any private disciplinary actions that may be taken against the Terminal Operators (by whomever), circumventing effective CFTC oversight of adequacy of such actions.

Must provide CFTC notice of disciplinary actions. Sanctions are subject to review either upon appeal or the CFTC's own initiative. CFTC has in the past required exchanges to increase penalties it believed inadequate. Disciplinary sanctions may also form the basis for denial or conditioning of floor broker registration.

No public posting of any private disciplinary actions that may be taken against Terminal Operators (by whomever), shielding such actions from customers.

Must post notice of disciplinary actions, including identity of the party, the nature of the violation, and the penalty imposed; must also notify NFA, which maintains a public data base on exchange disciplinary actions.

2. <u>CFTC Oversight</u>

Effective CFTC oversight is in serious question; existing legal framework does not fit:

- No CEA provisions or CFTC rules exist which set out a proprietary exchange's responsibilities to detect, deter and punish misconduct by its "non-member agents" who perform floor brokerage functions and solicit customer futures orders.

- No CEA provisions or CFTC rules exist which apply directly to trading or to customer communications by a proprietary exchange's "non-member agents" who perform floor brokerage functions and solicit customer futures orders.

- No CEA provisions or CFTC rules exist which provide a framework for how the CFTC should perform oversight of a proprietary exchange's self-regulatory activities.

No meaningful "rule enforcement" oversight -- what would the CFTC even look for in a rule enforcement review, when the Cantor Exchange has no legal obligation under its

2. <u>CFTC Oversight</u>

Extensive. Exchanges and exchange members operate in a closely supervised regulatory environment.

<u>Exchanges</u>

The CFTC conducts periodic rule enforcement reviews of exchanges. CFTC staff also closely examines the audit trail compliance of exchanges, but inexplicably has yet to apply the same standards or scrutiny to the Cantor Exchange.

<u>Members</u>

Exchange members are subject to numerous rules that the Terminal Operators will circumvent through form over substance of not being members of the Cantor Exchange.

Exchange members may separately be disciplined by the Commission for conduct addressed by exchange proceedings.

Exchange members can face denial or conditioning of floor broker and floor trader registration based on exchange proceedings.

Terminal Operators, however, avoid such serial sanctioning by the CFTC, because their

proposed structure to enforcement its rules against Terminal Operators through effective compliance and disciplinary programs?

3. **NFA Oversight**

None.

- NFA will not oversee the Terminal Operator's trade execution activities; NFA is not responsible for floor broker oversight because that responsibility is normally performed by the exchange on which a floor broker is a member.

- Terminal Operators will circumvent NFA sales practice rules and oversight because they are not registering as Associated Persons. (And since they are not members of the Cantor Exchange, they evade any sales practice requirements it imposes.)

- Similarly, their employer, Cantor Fitzgerald Securities, will also circumvent NFA sales practice rules and oversight, because the firm is not registering as a Futures Commission Merchant or Introducing Broker.

supervision and conduct is performed in secret.

3. **NFA Oversight**

Yes, over sales practices; N/A for trade execution.

- NFA oversight of floor brokers and floor traders is not necessary, because they are regulated by the exchange on which they are a member, unlike the Terminal Operators.

- Individuals who solicit futures business must work for a CFTC registered firm, join NFA as an associate member and register as an Associated Person; as NFA associate members, they are subject to NFA sales practice rules and oversight.

- Firms that solicit customer futures business must join NFA and register as a Futures Commission Merchant or an Introducing Broker; as NFA members, they are subject to NFA sales practice rules and oversight.

The exchanges also oversee the sales practice activities of their individual members and member firms.

ISSUE #5

IS IT CONTRARY TO THE PUBLIC INTEREST AND THE "OPEN AND COMPETITIVE" EXECUTION REQUIREMENT OF CFTC RULE 1.38, FOR A CONTRACT MARKET TO BE DESIGNED TO ALLOW TRADERS TO EXECUTE TRANSACTIONS "EVEN IF A BID OR OFFER SUPERIOR TO SUCH TRADER'S BID OR OFFER WOULD OTHERWISE BE AVAILABLE" (CFFE RULE 303 (b)(1))?

THE CANTOR EXCHANGE VIOLATES THE "OPEN AND COMPETITIVE" TRADING REQUIREMENT.

1. The Cantor Exchange will regularly allow non-competitive trading. In its simplest form, that non-competitive trading would occur in what is called "exclusive time" after any trade is made when the two parties to the trade may disregard all other bids and offers and negotiate larger quantities for their transaction at the original price. This practice encourages a form of block trading. It also means that a trader will be locked into a trade "even if a bid or offer superior to such trader's bid or offer would otherwise be available." CFFE Rule 303(b)(1). In addition, other types of non-competitive trades are allowed under the Cantor Exchange proposal. In the market crossing session, for instance, which is the only opportunity for customers to trade a smaller unit than the proposed $1 million minimum, the assigned match price "may be inferior to the prices that could otherwise be obtained," according to the Cantor Exchange's proposed disclosure statement submitted in June.

2. The block trading authorization is important as a matter of process and fairness. The Commission last spring extended the public comment period on a concept release designed to review whether block trading should be permitted on exchanges. The Cantor Exchange application jumps the gun on that rule making proceeding by seeking authorization to offer a block trading facility in contracts that are replicas of those traded on the Chicago Board of Trade where block trading is not allowed. If the Cantor Exchange insists on retaining its block trading-exclusive time rules, the Commission should defer approval of them until the Commission has taken final action on the block trading issues raised by its outstanding concept release.

3. In any event, the Cantor Exchange's non-competitive trading practices violate CFTC Rule 1.38. That rule requires that all executions of futures contracts must be done "openly and competitively." Nothing in that rule or its history has ever tolerated regular trading practices designed to freeze the bulk of market participants out of a market for a period of time while allowing trades routinely to be executed at prices other than the best price available. Indeed, years ago, members of Chicago exchanges were accused and convicted of criminal misconduct by foreclosing their customers from possibly getting the best price available. As the Seventh Circuit recognized, a broker's "deliberate refusal to pursue the best price the broker could obtain can constitute a scheme to defraud." U.S. v. Ashman, 979 F.2d 469, 478 (7th Cir. 1992). By design, the Cantor Exchange also refuses to allow its customers to receive the best prices available through trading practices that violate the longstanding open and competitive trading requirement. Unless changed, these trading practices are yet another legal deficiency in the Cantor Exchange application.

ISSUE #6

WOULD ALLOWING A NEW EXCHANGE TO ENGAGE IN ROUTINE NON-COMPETITIVE TRADING PRACTICES FOR U.S. TREASURY SECURITY FUTURES CONTRACTS THAT ARE LARGELY IDENTICAL TO CONTRACTS ALREADY COMPETITIVELY TRADED ON A LIQUID BASIS ON ANOTHER EXCHANGE CAUSE

- **PRICING DISTORTIONS;**
- **MARKET ILLIQUIDITY;**
- **WIDER BID-ASK SPREADS;**
- **INEFFICIENT HEDGING; AND**
- **INCREASED COST TO THE TREASURY (AND TAXPAYERS) FOR FINANCING U.S. DEBT?**