eurex us

June 24, 2004

Via Electronic Mail

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

2004 JUN 24 PM 2:38

RECEIVED
C.F.T.C.

Re: U.S. Futures Exchange, LLC Marketing Programs

Dear Ms. Webb:

As discussed with representatives of the Commodity Futures Trading Commission ("CFTC" or the "Commission") on May 4, 2004, as well as prior to that date, U.S. Futures Exchange, LLC ("Eurex US" or the "Exchange") is planning to initiate new marketing programs (the "Programs") designed to synchronize trading activity from various market participants in order to develop greater liquidity in its suite of treasury products. With the exception of one item – fee waivers for all transactions executed on the Trading System (discussed in more detail below) – the Programs will be directed solely at proprietary traders and will not affect customer-trading activity. The purpose of this letter is to more formally outline these Programs. Additionally, while we are of the opinion that the proposed Programs are "traditional," and thus not subject to our 30-day undertaking pursuant to a letter from the Exchange dated January 26, 2004,[1] we nonetheless appreciate the opportunity to present these items to you for your thoughts and comments.

The Programs

Our proposed Programs fall into four primary categories: (i) fee waivers; (ii) market maker stipends; (iii) revenue sharing; and (iv) an iPod promotional giveaway. These items will be discussed in turn:

Fee Waiver

The Exchange will waive all transaction fees from July 1 through December 31, 2004. This fee waiver extends to all transactions in all US Treasury futures and options products and applies to member and customer trades. It will also include any transactions executed on the Exchange's OTC Functionality (*i.e.* block trades, EFPs, EFSs, etc.). It should be noted,

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[1] *See also CFTC Order of Designation* (CFTC, Feb. 4, 2004), which ordered the Exchange to "provide to the Commission, one month in advance of its proposed effective date, any non-traditional form of incentive programs that the USFE plans to implement."

however, that clearing fees will still be charged. Also, telecommunication "line" fees will be charged to participants after a 6-month waiver of such fees.

Market Maker Stipends

The Exchange is going to introduce Market Maker ("MM") programs identified as Permanent Market Makers ("PMMs") and Private Market Makers ("PrMMs"). The terms of these programs are as follows:

The Exchange expects approximately 14 members to participate in the PMM program. PMMs must comply with the following:

[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
2yr U.S. T-Note Future (FTNS)	Front month contract until five exchange trading days immediately preceding the first day of the delivery month; afterwards market makers have the choice of quoting the front or the next contract month	3 ticks (= ¾/32)	10	70% of the daily trading period from 7:20 am to 2:00 pm CST on a monthly average
5yr U.S. T-Note Future (FTNM)		2 ticks (= 1/32)	25	
10yr U.S. T-Note Future (FTNL)		2 ticks (= 1/32)	25	
30yr U.S. T-Bond Future (FTBX)		4 ticks (= 2/32) or 3 ticks (= $1^1/_2$ 32)	20 or 10	

During a fast market (definition and announcement through the exchange) the obligations are changed as follows:

[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
2yr U.S. T-Note Future (FTNS)	Front month contract until five exchange trading days immediately preceding the first day of the delivery month; afterwards market makers have the choice of quoting the front or the next contract month	6 ticks (= $1^1/_2$ /32)	5	70% of the daily trading period from 7:20 am to 2:00 pm CST on a monthly average
5yr U.S. T-Note Future (FTNM)		4 ticks (= 2/32)	10	
10yr U.S. T-Note Future (FTNL)		4 ticks (= 2/32)	10	
30yr U.S. T-Bond Future (FTBX)		8 ticks (= 4/32) or 6 ticks (= 3/32)	10 or 5	

The markets must be made in at least 2 out of the 4 treasury futures contracts (i.e., 2 year, 5 year, 10 year and 30 year).

To comply with the PrMM program, each participant must comply with the following:

Contract	Month(s)	Bid/Ask Spreads	Strong Quantity	Weak Quantity	Time Period
2yr U.S. T-Note Future (FTNS)	Front month contract until five exchange trading days immediately preceding the first day of the delivery month; afterwards market makers have the choice of quoting the front or the next contract month	1 tick (= 1/64)	50	5	80% of the daily trading period from 7:20 am to 2:00 pm CST on a monthly average
5yr U.S. T-Note Future (FTNM)		1 tick (= 1/64)	100	10	
10yr U.S. T-Note Future (FTNL)		1 tick (= 1/64)	100	10	
30yr U.S. T-Bond Future (FTBX)		2 tick (= 1/32)	50	5	

Note: Strong and Weak quantities can be either bids or offers and may switch back and forth at the PrMM's Discretion.

It is anticipated that PrMMs will not quote during fast market conditions. Again, the markets must be made in at least 2 out of the 4 treasury futures contracts (i.e., 2 year, 5 year, 10 year and 30 year).

The Exchange also plans to implement a MM program to stimulate activity during European trading hours. The new program, entitled the European Hours Market Making program ("EurHrMM"), will be comprised of approximately 5 members. Each EurHrMM will be required to comply with the following:

Contract	Month	Bid/Ask Spread	Min Size	Time Period
2yr U.S. T-Note Future (FTNS)	Front month contract until five exchange trading days immediately preceding the first day of the delivery month; afterwards market makers have the choice of quoting the front or the next contract month	4 ticks (= 1/32)	5	60% of the daily trading period from 1:00 am to 7:20 am CST on a monthly average
5yr U.S. T-Note Future (FTNM)		3 ticks (= $1^1/_2$ /32)	10	
10yr U.S. T-Note Future (FTNL)		3 ticks (=$1^1/_2$ /32)	10	
30yr U.S. T-Bond Future (FTBX)		5 ticks (= $2^1/_2$ /32)	10	

During fast market (definition and announcement through the exchange) the obligations are changed as follows:

Contract	[illegible] Months	Bid/Ask Spread	Min Size	[illegible]
2yr U.S. T-Note Future (FTNS)	Front month contract until five exchange trading days immediately preceding the first day of the delivery month; afterwards market makers have the choice of quoting the front or the next contract month	8 ticks (= 2/32)	2	60% of the daily trading period from 1:00 am to 7:20 am CST on a monthly average
5yr U.S. T-Note Future (FTNM)		6 ticks (= 3/32)	5	
10yr U.S. T-Note Future (FTNL)		6 ticks (= 3/32)	5	
30yr U.S. T-Bond Future (FTBX)		10 ticks (= 5/32)	5	

Such markets must be made in 2 out of 4 of the treasury futures contracts.

The Exchange will reward each MM for compliance on a monthly basis. Compliant PMMs will receive $15,000 per month, compliant PrMMs will receive $25,000 per month, and Compliant EurHrMMs will receive $7,500 per month. Members may also choose to comply with both the PMM and EurHrMM programs, for which they will be entitled to a $22,500 per month stipend. Stipends will be available through the end of 2004 and will be awarded based solely on compliance with the market making requirements of the programs. There are no volume requirements to be eligible to receive market maker stipends.

Revenue Sharing

The Exchange will also adopt a Revenue Sharing program ("Revenue Sharing"). Revenue Sharing will be available to all compliant MMs from any MM program (with no volume requirements to get into Revenue Sharing),[2] as well as any other non-MM members that comply with the minimum qualification criteria during one of three compliance periods ("Early Volume Adopters" or "EVAs"). EVAs will qualify for Revenue Sharing by complying with the following:

Period	[illegible]	Minimum [illegible]
Jul. 12 – Jul. 31, 2004	11 of 15 days	500
Aug 1. – Aug. 31, 2004	16 of 22 days	500
Sep. 1 – Sep. 30, 2004	15 of 21 days	500
Oct. 1 – Oct. 31, 2004	15 of 20 days	1000
Nov. 1 – Nov. 30, 2004	15 of 20 days	1000
Dec. 1 – Dec. 31, 2004	15 of 21 days	1000

[2] However, in order to actually receive any funds as a part of Revenue Sharing, a MM will have to execute trades on the Eurex US screen. In other words, compliance with the MM program gets the participant into the Revenue Sharing pool; trading activity determines the amount of revenue that can be obtained by the participant.

The first compliance period will run from July 12, 2004 through September 30, 2004, the second compliance period will run from October1, 2004 through December 31, 2004, and the third compliance period will run from January 1 through December 31, 2005. Payouts to qualifiers will be based on a revenue pool made up of a percentage of revenues from all of the trading activity in the Exchange's US Treasury futures contracts ("Revenues") in 2005 and 2006. For first period qualifiers, the payout for 2005 will be their pro-rata share of 20% of Eurex U.S. 2005 Revenues, with a guaranteed minimum pool of $5 million and a maximum cap of $10 million. For second period qualifiers, the payout for 2005 will be their pro-rata share of 20% of 2005 Revenues, with a guaranteed minimum of $5 million and a maximum cap of $10 million. Third period qualifiers[3] will receive a pro-rata share based on qualifying volume during 2005 of 25% of 2006 Revenues, capped at $20 million, but with no guaranteed minimum.

A couple of important features of Revenue Sharing should be emphasized. First, only trades executed using funds held in a proprietary account as defined by CFTC Rule 1.3(y) will qualify. No trades executed on behalf of customers will apply towards the Revenue Sharing or MM programs. Further, only US Treasury futures trades will be applied. Third, only trades executed through the electronic order book will count. Thus, trades executed through the Exchange's OTC functionality (*i.e.*, block trades or EFPs) do not apply. Moreover, while Revenue Commission Agreement ("RCA") firms may participate, they may do so only above and beyond their trading commitments under the RCAs.[4] Finally, no participant in Revenue Sharing will be allowed to receive more than $5 per contract when calculating their payment.

IPod Giveaway

The Exchange also plans a small-scale promotional giveaway to any interested proprietary trader in return for trying out the Trading System for a limited time. Specifically, the Exchange will give an Apple iPod® to any proprietary trader willing to execute at least 3 trades a day during the month of July. The value of the iPod® is approximately $250 per unit and the Exchange intends to give away 100 units.

Analysis

Legal Requirements

Under its duties as a U.S. Designated Contract Market, the Exchange must abide by the CFTC Contract Market Core Principles, which include the requirement of an Exchange to provide protections against certain abusive trading practices. Relevant Core Principles include the duty to monitor trading to prevent manipulation, price distortion, and disruptions

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[3] Revenue Sharing for 2006 will only be open to PMMs and EVAs that qualify to receive a payout from the 2005 Revenue Sharing (i.e., the minimum qualification to participate in the 2006 Program would require at least one month in 2004 in which the participant met either the PMM or EVA minimum criteria.

[4] As part of the Exchange's merger with the former BrokerTec Exchange, seven of the shareholder firms of the former BrokerTec Exchange entered into RCAs with the Exchange. Under the RCAs, the seven firms are obliged to prepay trading fees to the Exchange that are creditable towards transactions in U.S. Treasury complex futures and options. The term of the RCAs is 36 months and collectively obliges the firms to pay approximately $18 million in prepaid trading fees. The prepaid fees would be creditable against an RCA participant's proprietary transactions and certain non-discretionary customer transactions. In return (and in the context of the wider merger), the minority shareholder entity (created for purposes of the merger and owned and controlled by shareholders of the former BrokerTec Exchange) received a 20% equity stake in the Exchange, the right to appoint three of the Board's 12 directors, and the right to nominate, but not select, the Board's three public directors.

of the delivery or cash-settlement process (Core Principle 4), the adoption of position accountability rules to prevent manipulation (Core Principle 5), the duty to provide a competitive, open, and efficient market and mechanism for executing transactions (Core Principle 9), the duty to establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants (Core Principle 12), and the duty to avoid unreasonable restraint of trade and imposing any material anticompetitive burden on trading on the contract market (Core Principle 18).

The Exchange has contracted with the National Futures Association ("NFA") to provide certain regulatory services under a Regulatory Services Contract ("RSA"). These services include, among others, monitoring the market for trading ahead of customers, front running, direct and indirect crossing, taking the other side, prearranged trading, wash trading, money passing, counterparty trade percentages, stop order fishing, marking the close, error account and transfer trade activity and off-exchange transactions. The Commodity Exchange Act and Eurex US and CFTC rules prohibit such activities.[5]

The Exchange has briefed NFA staff, including Yvonne Downs and her staff, about its intended plans. The NFA assures the Exchange that it is more than capable of monitoring the Eurex US treasury futures markets for signs of improper trading activity stemming from a member's participation in one of the Programs. Certainly, surveillance will involve the awareness of which members participate in the Programs and their relative trading levels. The NFA intends to adjust its surveillance and make an additional effort to monitor the activities of all compliant MMs and EVAs. Such additional efforts will include reviewing if an MM or EVA shows up on a daily exception report, monitoring all such traders for any signs of market manipulation, and the use of other tools of compliance at the NFA's disposal.[6]

Sampling of Incentive Programs at U.S. Exchanges

In order to frame its Programs in a lawful manner, Eurex US commissioned a study of incentive plans operated by various U.S. commodity futures exchanges (the "Study"). The exchanges included in the Study are: (i) The New York Mercantile Exchange Inc. ("NYMEX"); (ii) the Chicago Board of Trade ("CBOT"); (iii) the London International Financial Futures Exchange ("Liffe") and (iv) the Chicago Mercantile Exchange ("CME"). A summary of the Study follows[7].

<u>Fee Waiver Programs</u>

The Commission has a long history of accepting fee waiver programs for new products and/or new exchanges. Without providing every example of a fee waiver, we submit the following examples for consideration:

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[5] See, *e.g.*, 7 USC Sections 6b (prohibitions against fraudulent transactions, including bucketing or offsetting other customer orders) and 6c(a)(prohibition against wash sales, accommodation trades, and fictitious sales). See also CFTC rules 1.38 (competitive execution of trades required for most but not all trades) and 1.39 (cross-trading permitted under certain circumstances) and Eurex US rules 307-309, and 403

[6] Specific criteria used to detect trading patterns are generally not made available since the dissemination of surveillance procedures could make it easier for market users to fashion abusive trading schemes that evade detection.

[7] Eurex US is only providing a sampling of the programs instituted by other exchanges. Should the Commission require additional information on this topic, we would be delighted to provide it.

- *Eurodollar After-Hours Market Maker Program*: In August 2003, CME established a Market Maker program for Eurodollar futures traded on GLOBEX during non-floor trading hours. The electronic Market Maker program was open to CME members, lessees and those who traded propriety accounts at member firms. Participants who qualified as Market Makers had their GLOBEX system fees waived for Eurodollar futures during non-floor trading hours. Through the program, they were also eligible for a waiver of their GLOBEX connectivity fees up to a maximum of $2,500 per month. Finally, CME reduced GLOBEX fees for members, member firms and lessees (or those conducting a vast majority of Eurodollar trades) from $0.25 to $0.10 per side.[8]

- *Fee waiver for Dow TMI Futures and mini-sized Dow Jones Options*: In February 2004, CBOT waived all exchange fees associated with trading in CBOT U.S. Total Market Index Futures and in mini-sized Dow Jones Industrial Average options through May 31, 2004.[9]

Market Maker Stipends

Market maker stipend programs are also quite common in the futures industry. Similar to fee waivers, these programs are often instituted when an exchange is attempting to launch a new (typically competing) contract. Some examples of these types of programs include:

- *Specialist market maker program*: In 1998, NYMEX established a Specialist Market Maker ("SMM") program for certain new and low volume contracts traded on its exchange. At NYMEX's discretion it would appoint one SMM for each contract market that it determined would benefit from the program. Under the incentive program, the SMM would receive a monthly payment, known as a contract development fee, of $8,000 per month if monthly customer trading volume was less than 3,500 contracts. Once monthly customer trading volume exceeded 3,500 contracts, the SMM would receive $8,000 per month plus a per contract fee for each transaction in excess of 3,500 that involved a customer order.[10]

- Liffe recently introduced a program for its new Eurodollar contract[11] whereby Designated Market Makers ("DMMs") appointed by the Exchange are obliged to make two-way prices on Liffe Connect® and, where these obligations are met, the DMMs shall receive benefits as described below. This program runs from March 18, 2004 through March 16, 2005. Certain of the benefits for the DMMs, which combine elements of fee waiver, stipend payments and revenue sharing, include:

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[8] *Id.*

[9] See CBOT Press Releases (Feb. 10, 2004) available at *http://www.cbot.com/cbot/pub/cont_detail/0,3206,1036+17850,00.html.*

[10] See further NYMEX Rulebook: Rule 6.45 Specialist Market Maker Program available at *http://www.nymex.com/jsp/resources/rule_main.jsp?pg=5.* NYMEX maintains an application process for SMMs. Prospective SMMs must be exchange members, member firms or others that have working capital in excess of $500,000.

[11] Liffe Circular No: 04/13, January 30, 2004.

(a) a rebate equal to 100% of Exchange transaction charges and LCH-Clearnet clearing charges in respect of business executed by DMMs on Liffe Connect in a market making capacity; and

(b) a share of 15% of the net revenue of the Contract[12] or a cash stipend (whichever is the greater) where:

(i) 50% will be divided equally amongst all DMMs; and

(ii) 50% will be divided amongst all DMMs on a pro rata basis according to the volume executed by them on Liffe Connect in a market making capacity.

Revenue Sharing

Similar to the other programs, a number of exchanges have used some form of revenue sharing in the early stages of a contract. Examples include:

- *Incentive Programs on NYMEX Clearport*[13]: In March 2003, NYMEX modified its incentive programs for NYMEX Clearport by implementing a revenue sharing plan. Under the plan, 50% of the revenues from NYMEX Clearport were allocated to an intermediary incentive pool. At the end of each month, the qualifying intermediaries receive a pro-rata share based on the volume for which they were responsible. Under the new incentive program, there were no minimum volume requirements for participation. Moreover, under the terms of the program, any participant who made a bid or offer on a coal futures contract received $1.00 and the participant on the other side of the trade paid an all inclusive fee of $2.50 per contract.[14]

- *Eurodollar Back Month Incentive Program*: In March 2003, CME began a 10-month volume incentive program that focused on developing increased volume and liquidity in the "back month" Eurodollar futures contracts (*i.e.* those contracts that trade three to 10 years in the future). The program was open to any individual account meeting minimum volume thresholds of 20,000 sides per day in monthly average daily volume with at least 20 percent of the volume generated in the "back month" Eurodollar futures contracts. The program involved a pool derived from a 5% share in revenues of Eurodollar futures contracts and the payout was based on qualifying during each of two 5-month periods. The pool for each period was capped at $2M per period and each qualifying participant received a pro-rata share of the revenue pool.[15]

[12] Equal to the Contract's gross revenue minus Exchange transaction fee rebates.

[13] In addition to the incentives specified, under both the original and modified NYMEX ClearPort Incentive program, a quarterly or regular interval stipend was given to participants at the sole discretion of NYMEX. See Broker Incentive Program (3/24/03) available at *http://www.nymex.com/jsp/shareholder/notice_to_member.jsp?id+ntm132&archive=2003.*

[14] See NYMEX Press Release: Exchange Expands Incentive Programs on NYMEX ClearPort (March 31, 2003) available at *http://www.nymex.com/jsp/news/press_releas.jsp?id+pr2003033a.*

[15] See CME News (Jan. 17, 2003) available at *http://www.cme.com/abt/news/CME_Offers_New_Incentive_Program_in_Eurodollars;_Refines_Existing_Tiered_Pricing_Program_.html*

Conclusions Regarding the Study

An analysis of these precedents and relevant legal and regulatory requirements leads to the following general principles relating to incentive plans under U.S. legislation:

- Incentive plans are generally transparent, in that they are specified in advance and are publicized to the press, by postings on relevant websites and in communications to members and regulators.

- Incentive plans should not encourage any person to enter into transactions other than for proper trading purposes. As set forth above in greater detail, the Commodity Exchange Act and CFTC and Eurex US rules[16] are designed to protect market participants from certain abusive trading practices, including market manipulation, wash trades, inappropriate cross trading, trading ahead of customer orders, and any fraudulent activity in connection with commodity futures trading.

- Incentive plans must be consistent with a reliable, undistorted price-formation process, as required by Core Principles 4, 5, 9, 12 and 18 and Exchange Rule 308(k).

- Incentive plans are applicable to all exchange members, or a defined class of members, and not applied in a discriminatory manner as required by Core Principal 18.

Application to the Proposed Marketing Programs at Eurex US

As can been seen from the examples described above, the Eurex US Programs are in line, and consistent, with incentive programs regularly used at other U.S. exchanges (as well as exchanges operating pursuant to No-Action Letters from the Commission, e.g., Liffe). Fee waivers, market maker stipends and revenue sharing have all been in effect (and are in effect) in varying degrees at many U.S. exchanges (or foreign exchanges operating in the U.S.). We therefore believe that our proposed Programs are, indeed, "traditional."

Additionally, we would like to reiterate that, pursuant to the Regulatory Services Agreement with NFA, surveillance is conducted on behalf of the Exchange for any potential improper activity by those participating in market maker and other marketing programs. The NFA reports to Eurex US on these matters. The Exchange then takes appropriate action. As noted above, Eurex US and the NFA will take special steps to review trading activity by MMs, as well as those participants who are eligible for Revenue Sharing.

Finally, and perhaps most importantly, with the exception of the fee waiver program, all of the proposed Eurex US Programs are solely for proprietary business. Thus, there is no risk of customer business being conducted on Eurex US to the detriment of the customer's interest as a result of any of its proposed Programs.

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[16] *See* 7 USC Sections 6b and 6c(a), CFTC rules 1.38 and 1.39, and Eurex US rule 308.

We appreciate the opportunity to review these Programs with you and would be delighted to discuss these matters further, if you are so inclined.

Very truly yours,

James M. Falvey
General Counsel

CC: David Van Wagner
Duane Andresen