

COMMENT

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Via eRulemaking Portal
Mr. David Stawick
Secretary to the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

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U.S. DEPARTMENT OF THE TREASURY

Re: Supplemental Statement Regarding Comments Posted by the CME on Proposed Rules on Block Trading and EFP and EFS Transactions, 73 Fed.Reg. 54097, September 18, 2008

Dear Mr. Stawick,

This is in response to a recommendation contained in the comment letter filed by the Chicago Mercantile Exchange ("CME") in connection with Federal Register Release 73 Fed.Reg. 54097 concerning, among other things, guidance on block trading standards. ELX Futures, L.P. ("ELX" or "Electronic Liquidity Exchange") filed its own comment letter on January 5, 2009. The CME's comment at issue has significant anticompetitive implications for ELX inasmuch as ELX has an application pending with the CFTC for approval as a Designated Contract Market ("DCM") to trade products that compete directly with futures contracts that are mainstays of the CME since its acquisition of the Chicago Board of Trade, specifically United States Treasury Futures Contracts. Presently, only the CME offers exchange based trading in U.S. Treasury Futures.

ELX finds unacceptable the recommendation made by the CME that, as the DCM at which the liquid U.S. Treasury Futures Contracts are traded, the CME should be granted the authority to determine the appropriate minimum block trading size for ELX and any other fledgling competitor. The CME writes:

“in order to receive safe harbor treatment, any DCM listing a particular contract should be required to set its block trade threshold size at the level which would constitute an appropriate minimum size for block trades in the most liquid substantially identical contract on any DCM, to the extent that it is able to determine such appropriate minimum size.” (See Page 4 of CME Comment Letter) (The entire section under discussion can be found at the end of this letter)

Delegating rule-making authority to the CME to set block trading requirements for competing markets is nowhere supported or proffered in the CFTC’s proposal. Indeed, on its face the CME’s recommendation is anticompetitive and flies against the CFTC’s statutory mandate contained in Section 15(b) of the Commodity Exchange Act to regulate in a manner that follows the least anticompetitive path possible in maintaining the public’s interest in the protections of the antitrust laws. Contrary to the CFTC’s mandate, the CME’s proposal would have the CFTC implement a regulation that protects established exchanges from competitors which might be aided by employing more aggressive practices than an established market may choose within appropriate bounds of market integrity. The CME would have the CFTC hand over the regulatory authority to the CME to set the block trading standards based on its own competitive wishes. Competition can be based not on just on price, but on quality or other attributes – here including block trading size.

The crux of CME’s argument is that a new market with a “copycat” contract can do great harm to an established, liquid market by enticing some of its liquidity away through liberal block trading rules. However, the issue cited by the CME as a problem inherent with allowing a competitor exchange from setting a lower block trading threshold than an established market uses – namely the potential harm to liquidity in the established market by encouraging competition in established products – is not a rational concern because products traded at the CME and elsewhere are not fungible.

While contracts at different exchanges may have similar, or the same, terms and conditions, and may thus be termed “competitive contracts,” in the sense that they may fulfill the same or similar demands and thus demand may be elastic, they are not fungible contracts inasmuch as they clear at different clearinghouses and cannot be offset against each other. The data is clear that similar, non-fungible contracts are complementary and supportive of each other, and are in no way destructive of each other, as is shown later, below.

ELX strongly maintains that the issue at hand has nothing to do with the CME’s expressed concern about market integrity, but everything to do with the impact that implementing its suggestion would have in creating a barrier to competition. If we accepted, as CME contends, that competition from block trading standards can hurt established markets, and implicitly the public interest, the logical inference from this argument is that any competition against established markets such as CME’s is highly suspect and should be frustrated or stopped. ELX argues against accepting as policy a

recommendation that would produce the anticompetitive effect of protecting a monopolist instead of enlarging the market

At ELX, we believe that competition needs to be encouraged, not further thwarted.¹ For an upstart exchange like ELX, so many barriers to competition already exist in the futures exchange arena that adding barriers should be avoided at all costs².

But an additional problem with the proffered argument - that competition from non-fungible similar or competitive contracts can harm the established, liquid contract - is that it is unambiguously rebutted by the data.

As shown below using relevant examples of comparable non-fungible contracts involving different futures exchanges, and also the OTC market and a futures exchange, the CME's purported concern for the market's welfare has no basis in fact.

On February 3, 2006, the Intercontinental Exchange ("ICE") offered for electronic trading futures contracts in crude oil that mirrored the terms and conditions of the well-established crude oil futures contracts offered for floor trading on the NYMEX. The ICE contracts, in fact, used the NYMEX final settlement price as its own final cash settlement, and so could not have been more alike to the established contract. For the year 2005, the year before ICE introduced non-fungible copies of the NYMEX futures

¹ In a Department of Justice comment letter dated January 31, 2008 addressed to the Department of the Treasury (TREAS-DO-2007 0018) DOJ commented on the very issue of the benefits that users of futures markets could gain from added competition, as follows:

In contrast to futures exchanges, equity and options exchanges do not control open interest, fungibility, or margin offsets in the clearing process. This lack of control appears to have facilitated head-to-head competition between exchanges for equities and options, resulting in low execution fees, narrow spreads, and high trading volume. Equities and options execution systems are also very sophisticated and feature-rich, more so than futures contract execution systems.

Although characteristics of the equities and options markets differ from those of financial futures markets, the clearing processes and related regulatory framework in equities and options markets appear to provide useful lessons in the futures arena. In light of the potential competitive benefits that could flow from regulatory changes that would facilitate competition in financial futures exchange markets, the Department recommends that Treasury propose a thorough review of futures clearing and its alternatives.

<http://www.usdoj.gov/atr/public/comments/229911.htm>

² ELX is the fourth exchange over a ten year period trying to compete with the CME and its predecessor, the CBOT, in offering trading in U.S. Treasury Futures Contracts. The other three efforts failed.

contract, NYMEX traded 59.6 million crude oil futures contracts (source:NYMEX.com). In 2007, the year after ICE launched its copy-cat contracts, ICE traded 51.4 million crude oil futures contracts, and NYMEX traded 121.5 million crude oil futures contracts, more than doubling NYMEX's volume from just one year before ICE started to compete. If we add ICE's volume with NYMEX's volume in 2007, total crude oil futures volume tripled from the year before to the year after the start of competition from a non-fungible copycat contract.

(Source:<http://files.shareholder.com/downloads/ICE/0x0x154677/65066e8a-6a78-4ac3-aad4-c96bf05aece/284485.pdf>)

The comparison of OTC and futures markets in domestic interest rate contracts provides another relevant comparison of the effect of non-fungible comparable products on each other's liquidity. Over the course of several years we have seen the positive influence on futures volume from OTC interest rate contracts that mirror or closely resemble the terms and conditions of regulated interest rate futures contracts. The OTC contracts are not fungible with the futures contracts, and yet have not decreased volume in the regulated markets. To the contrary, it is widely accepted that the OTC markets have added significant volume to the interest rate futures markets through arbitrage, added price discovery, and increased need for hedging risk from OTC exposure.

As early as November 1999, The Report of the President's Working Group on Financial Markets ("Over-the-Counter-Derivatives Markets and the Commodity Exchange Act," <http://treas.gov/press/releases/docs/otcact.pdf>) noted the growing convergence between the terms and conditions of interest rate OTC contracts and interest rate futures contracts:

As OTC markets develop, however, the extent to which market participants engage in large numbers of transactions with similar terms increases, because certain instruments serve the risk-management needs of a large number of market participants. Thus, the opportunity to negotiate the terms and conditions of an instrument may exist, but in practice this opportunity may not be used to a great extent for certain types of instruments, such as certain "plain vanilla" interest rate swaps. Moreover, although the widespread use of innovations such as electronic trading and clearing have the potential to increase efficiency and reduce systemic risk, they could also blur some of the distinctions between exchange-traded and OTC instruments.

According to a study presented by the Bank for International Settlements (BIS) in Paris in December 1-2, 2008, ("On-exchanges and OTC derivatives statistics The BIS statistical Framework," <http://www.world-exchanges.org/files>), as OTC interest rate contract volume expanded from 2005-2008, there was a similarly significant increase in volume in non-fungible exchange traded interest rate futures contracts. As stated by the President's Working Group, the OTC contracts are mostly "plain vanilla" copies of the exchange traded futures, and thus the parallel increase in volume across markets is a fair

relationship rather than two individual and unrelated events. (BIS reports a 50% volume increase in interest rate futures occurred from the first half of 2005 to the second half of 2008 and an 87.5% increase occurred in OTC interest rate contracts during the same time period; See Accompanying BIS Chart on page 7).

The CME does not allow open access for other exchanges to use its clearinghouse. Even if the CME's argument had merit – and we dispute it and have disproven that a non-fungible competing contract could harm a liquid contract - the CME controls the remedy to its asserted problem. By opening up its clearinghouse the CME can allow for fungibility between products and eliminate any liquidity or market integrity concern whatsoever, although its exchange business might suffer. By locking out competitive exchanges from using its clearinghouse, the CME has guaranteed that competitive contracts could not clear there and thus would not be fungible with the CME products. As the leading domestic exchange offering financial futures contracts - and the only domestic exchange currently offering U.S. Interest Rate Futures Contracts - this represents a monopolist position by the CME vis a vis most financial futures, including U.S. Treasury Futures Contracts.

If competitive contracts at different exchanges were allowed to compete on price, quality of technology, service, and innovation, but were otherwise fungible, liquidity would shift from the exchange offering lesser services at higher prices to the other exchange. Users of the contract would enjoy a single unified pool of liquidity, but no single corporation could control fees and other terms of service. Without fungible clearing, another exchange seeking to shift liquidity away from the CME with a product sharing identical terms and conditions, but without fungibility, would find it a difficult job to shift liquidity using the normal tools available to a typical competitor because of the ownership and control the CME has over the clearinghouse that clears futures in the existing liquid market.

Although it may seem obvious, the context in which the generic language of the CME's proposal is stated nonetheless should be highlighted. Although the CME looks to apply its proffered standard – which we contend is impermissibly anticompetitive - on “any DCM,” thus appearing to capture a wide net of affected exchanges, the reality is that the CME executes and clears more than 95% of U.S. regulated futures volume. The CME, thus, is virtually the sole beneficiary of its “generic” standard. The CME is asking the CFTC in essence to delegate to it, a private company, and a monopoly, the power to set standards that affect competitive conduct among its peers and would-be peers. ELX, of course, is a pending competitor, and strongly objects to any delegation of power by the CFTC to the CME, a private company, to establish block trading thresholds or any other standard that might affect ELX as a competitor, or that might further deter, inhibit or prohibit market competition.

CONCLUSION

In conclusion, the notion that a non-fungible contract with identical terms and conditions to an established product steals liquidity from the mature market is certainly disproven from the available data, and is a protectionist argument that cannot withstand scrutiny beneath face value. Given the CME's monopoly position in the liquid market it should not be dictating the standards of competition – whether block size or any other market attribute.

Thank you for your consideration, and please include this comment in the public comment file.

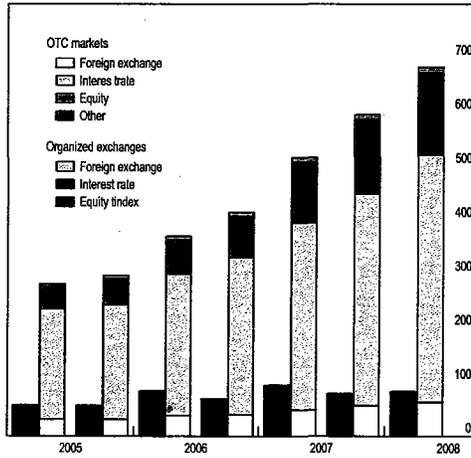
Very truly yours

A handwritten signature in black ink, appearing to read "Neal Walkoff". The signature is written in a cursive, flowing style with some loops and flourishes.



Global derivatives market

By market risk category¹



¹ Notional amounts outstanding in trillions of US dollars.

Sources: FOW TRADEdata; Futures Industry Association; BIS

Text of CME's Section on Setting Block Size

(c) Any DCM listing a particular contract should set its block trade threshold size at the level which would constitute an appropriate minimum size for block trades on the most liquid DCM which lists a substantially identical contract.

The Commission has stated in a footnote in the notice of rulemaking that the proposed guidance regarding threshold size for block trades "could result in different DCMs arriving at different minimum size requirements for the same or similar futures contracts, if the liquidity and volume on each DCM is different." 73 FR 54100, fn. 14. We believe that, where the Commission's suggested formulation is being relied upon by a DCM for purposes of falling within the acceptable practices safe harbor, a DCM should be required to set its minimum block trade size at a level that would be appropriate for the most liquid substantially identical contract that is trading on any centralized DCM market. Indeed, it appears that, in its July 1, 2004 NPRM, the Commission may have adopted the view that trading in all markets offering similar contracts should be considered, by defining the "relevant market" as "the subject futures or options market, any related derivatives market, and/or the underlying cash market, as appropriate." (Emphasis added). 69 FR 39885.

In addition, as noted above, the currently proposed guidance states that a DCM could estimate an appropriate minimum block trade size for new contracts based on market data relating to the same contract traded on another exchange. If a DCM were permitted to set a minimum size for block trades in a contract that it is newly listing, without considering available information about trading activity in a substantially identical liquid market on another DCM, it could impair the usefulness of the price discovery information being provided by the previously listing DCM by setting its own threshold too low. It should be noted that we are not suggesting that if a DCM sets a higher block trade size than what the guidance defines as an appropriate minimum, any DCM that subsequently lists a substantially identical contract must adopt that higher threshold. Rather, in order to receive safe harbor treatment, any DCM listing a particular contract should be required to set its block trade threshold size at the level which would constitute an appropriate minimum size for block trades in the most liquid substantially identical contract on any DCM, to the extent that it is able to determine such appropriate minimum size.²