February 8, 2010

VIA ELECTRONIC MAIL

Richard A. Shilts
Acting Director, Division of Market Oversight
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

Re: The Board of Trade of the City of Chicago, Inc. ("CBOT") Market Regulation Advisory Notice RA0907-1

Dear Mr. Shilts:

CBOT hereby responds to the Commission's letter dated January 22, 2010, with respect to CBOT's Market Regulation Advisory Notice RA0907-1 (the "Advisory Notice"). For the reasons discussed below, the Advisory Notice does not constitute a "false certification" within the meaning of Commission Regulation 40.6(b). Moreover, neither the Advisory Notice nor CBOT Rule 538 ("Exchange for Related Positions") violates Core Principle 18 (Antitrust Considerations). ELX Futures, L.P.'s ("ELX") request for a stay of the Advisory Notice should be denied and the Commission's inquiry should be terminated.

I. Executive Summary

On July 6, 2009, ELX requested approval from the Commission of an amendment to its non-competitive trading rule respecting Exchange for Related Future Positions ("EFRP") to permit Exchange of Futures for Futures ("EFF") transactions (the "EFF Rule"). In this filing (the "Rule Filing")[1], ELX also requested that the Commission issue an order directing CBOT to amend *its* rules to permit EFF transactions. ELX admitted in its Rule Filing that CBOT Rule 538 needed to be amended "in order to give effect" to ELX's EFF Rule. (Rule Filing at 2.) Clearly, ELX sought to enable market participants to move open interest from CBOT to ELX through non-competitive trades that are prohibited by CBOT rules.

On or about October 5, 2009, ELX's EFF rule was "approved" by the Commission because ninety days passed and the Commission took no action. The Commission did not grant ELX's request for an order directing CBOT to permit EFF transactions. CBOT's rules prohibiting prearranged, non-competitive transactions barred the ELX EFF transaction and remained in effect.

[1] The filing is titled "Request for Approval of Amendment to ELX Futures, L.P. Rule IV-15(a)(iv) and (v) to add an Exchange of Futures for Futures, or "EFF," Rule to the Rule Governing Exchange for Futures for Related Positions."

On October 14, 2009, ELX issued a press release falsely stating that the Commission's approval of the EFF Rule gives "traders the ability to move positions between clearinghouses." In a Memo to Market, ELX further misled the market by indicating that an EFF transaction would comply with CBOT rules and would not constitute a market offense. (*See* ELX Memo to Market, attached hereto as exhibit A.) ELX knew CBOT Rule 538 did not permit EFFs and knew that the Commission did not grant ELX's request to amend that rule; ELX's releases were false and improperly urged that market participants violate CBOT rules.

In response to ELX's Memo to Market, CBOT issued an advisory notice clarifying that CBOT Rule 538 had not been amended and that CBOT's rules have "*never* permitted a futures contract to be used as the related position component of an EFR transaction." (Advisory Notice (emphasis added.)) On October 20, 2009, ELX wrote the Commission alleging that CBOT's Advisory Notice was a "false certification" under Commission Regulation 40.6(b) and that it violated the prohibition on "unreasonable restraints of trade" contained in Core Principle 18. ELX requested that the Commission issue a "stay" of the Advisory Notice (the "Request for Stay"). In response to ELX's Request for Stay, the Commission issued a set of questions to CBOT seeking additional information related to the Advisory Notice and CBOT Rule 538. Among other things, the Commission asked CBOT to explain the basis for CBOT's decision not to permit EFFs and whether its Advisory Notice (and CBOT Rule 538) violated Core Principle 18.

On November 16, 2009, CBOT submitted its response to the Commission's inquiry (the "November 16 Submission," attached hereto as exhibit B). In a letter dated January 22, 2010, the Staff challenged certain portions of CBOT's response and issued follow-up questions to CBOT. The follow-up questions issued by the Staff again requested that CBOT explain the basis for CBOT's decision not to permit EFFs and whether its Advisory Notice (and CBOT Rule 538) violated Core Principle 18. CBOT's responses to the Commission's second set of questions are set forth below.[2]

The Commodity Exchange Act (the "CEA") promotes open and competitive trading. Non-competitive trades, including EFFs, are permitted only if effectuated pursuant to the rules of the contract market *on which the transaction is sought to be effectuated*, and those rules have been submitted to and approved by the Commission and specifically provide for the non-competitive execution of such transactions. (Commission Regulation 1.38.) CEA Section 5(b)(3)(B), which sets out the three non-competitive trades that a designated contract market may authorize, excludes the EFFs proposed by ELX. The Commission recently opined that the "implicit assumption" in Regulation 1.38 is that "trading should take place on the centralized market unless there is a compelling reason to allow certain transactions to take place off the centralized market."[3] The Commission further explained that "[i]f these transactions become the exclusive or predominant method of establishing or offsetting positions in a particular market, it might jeopardize the centralized market's role in price discovery and would not comply with Core Principle 9 (Execution of Transactions), which provides that trading be competitive, open and efficient."[4]

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2 CBOT hereby incorporates its November 16 Submission in its entirety into the instant response.

3 *See* Execution of Transactions: Regulation 1.38 and Guidance on Core Principle 9, 73 Fed. Reg. 54097, 54099 (Sept. 18, 2008).

4 Id.

The Treasury complex at both CBOT and ELX are liquid markets and there is no legitimate reason to permit a non-competitive transaction without any economic substance that will cause sudden, inexplicable changes in open interest. Any trader with a position at CBOT in a Treasury contract can quickly and easily exit that position and reestablish it at ELX by simultaneously buying and selling at the respective exchanges on their electronic systems. Our records indicate that CBOT has, at all relevant times related to such transactions, had narrow spreads and substantial size bid and offered at the inside market. It is our understanding that ELX offers similar narrow spreads and ELX reported record volume in October 2009. Thus, CBOT does not believe it is in the interest of the market or of its customers to offer holders of open interest the opportunity to eliminate their positions and open interest without any legitimate trade. Accordingly, there is no reason – let alone a "compelling reason" – to permit EFF transactions in its markets. On the contrary, CBOT determined, long before ELX adopted and submitted its EFF rule to the Commission for approval, that liquidity and transparency are best preserved if EFFs were not permitted. CBOT's position on this matter is reflected in the text of CBOT Rule 538 and explained in more detail in the Advisory; both are consistent with Regulation 1.38 and Core Principle 9.

Moreover, contrary to ELX's representations, CBOT is not obligated under Regulation 1.38, or any other provision of the CEA, to adopt ELX's EFF Rule. Indeed, the plain language of Regulation 1.38 makes clear that each *individual* contract market is granted discretion to permit non-competitive trading pursuant to *its* written rules for *its own* markets, subject to Commission approval; it does not provide that the non-competitive trading rules adopted by contract market A and approved by the Commission are binding on contract markets B, C, and D or that those contract markets must themselves adopt and submit for approval the exact non-competitive trading rules of contract market A.[5] Rather, it is well-established that an exchange may and should have different non-competitive trading rules for its various contracts depending on market need and the legitimate expectations of its customers. ELX advocated this very position before the Commission in early 2009.[6]

Furthermore, CBOT has determined that the EFF contemplated by ELX's EFF Rule would violate its rule prohibiting wash and fictitious trades. Unlike the Exchange of Futures for Physicals ("EFP") or Exchange of Futures for Risk ("EFR") permitted on CBOT, the EFF contemplated by ELX's EFF Rule does not involve any basis risk. Rather, the purported transaction involves two identical contracts – CBOT's Treasury futures contracts and copycat ELX Treasury futures contracts – and its sole purpose is to move open interest from CBOT to ELX while negating market risk. In other words, the ELX EFF effectively produces a financial nullity. As discussed in more detail below, CBOT's wash trade rule was approved by the Commission well before ELX submitted its Rule Filing, and the EFF violates this rule under long-standing Commission precedent.

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[5] CBOT notes that if the Commission were to improperly force CBOT to amend its rules to permit non-competitive trades in the form of an EFF, as ELX requests, such action would effectively allow parties to circumvent CBOT's block trading rule because ELX's block trading thresholds are substantially lower than CBOT's. Specifically, parties would be permitted to execute block trades on ELX at the lower threshold and then simply transfer the position to CBOT via an EFF, completely undermining CBOT's block trading rule.

[6] *See* Letter from ELX to Commission dated February 23, 2009, attached hereto as exhibit C.

In addition to being consistent with Commission Regulation 1.38 and the Commission's precedent on wash trades, CBOT's Advisory Notice and Rule 538 do not violate Core Principle 18. Core Principle 18 – which specifically cites antitrust law in its title, text and legislative history – provides, in relevant part: "Unless necessary or appropriate to achieve the purposes of this chapter, the board of trade shall endeavor to avoid . . . . adopting any rules or taking any actions that result in any *unreasonable restraints of trade*." (Core Principle 18 (emphasis added).) In neither its Rule Filing nor its Request for Stay (nor any in subsequent submission) has ELX purported to explain how the Advisory Notice and CBOT Rule 538 violate Core Principle 18. Instead, what ELX has argued is that Core Principle 18 somehow obligates CBOT to facilitate the transfer of its open interest from CBOT to ELX to foster the growth of ELX's business. Contrary to ELX's contention, it is well-established antitrust law that a refusal to assist a competitor is not an unreasonable restraint of trade.

Moreover, in addition to not being obligated to assist its competitors, CBOT had reasonable economic (and business) justifications for limiting the scope of CBOT Rule 538 to exclude EFFs when the rule was adopted (as presumably did ELX for its EFRP rule before proposing to amend it last summer) and issuing the Advisory Notice. As previously noted, CBOT has concluded that the transactions contemplated by ELX's EFF Rule, if effectuated, would adversely impact transparency and liquidity in its Treasury futures market. As the Commission is aware, the success of a contract market in the futures industry depends on the liquidity and transparency of its markets. Thus, CBOT was not only justified in excluding EFFs from Rule 538, but it also was justified in issuing the Advisory Notice in response to ELX's public statements regarding the meaning of CBOT Rule 538, which were false and intended to induce market participants to violate the rule.

For these reasons, and the reasons set forth below, the Advisory Notice does not violate Regulation 40.6(b), and neither the Advisory Notice nor CBOT Rule 538 violates Core Principle 18. Accordingly, ELX's Request for Stay should be denied and the Commission's inquiry into this matter terminated.

II. Background

In accordance with Core Principle 9 and Commission Regulations 1.38 and 1.39, CBOT's rules prohibit non-competitive trades except in limited circumstances. (*See* CBOT Rule 539.) The only prearranged trades permitted on CBOT are block trades made pursuant to CBOT Rule 526 and EFRPs made pursuant to CBOT Rule 538. Specifically, CBOT Rule 538 permits three types of EFRP transactions: (i) EFP; (ii) EFR; and (iii) Exchange of Options for Options ("EOO").[7] As authorized by the CEA, CBOT Rules 526 and 538 were self-certified, without subsequent objection from the Commission.

[7] In relevant part, CBOT Rule 538 provides:

> **538. EXCHANGE FOR RELATED POSITIONS**
> The following transactions shall be permitted by arrangement between parties in accordance with the requirements of this rule:
>
> Exchange for Physical ("EFP") – A privately negotiated and simultaneous exchange of an Exchange futures position for a corresponding cash position.

In its Rule Filing, ELX asked the Commission for, among other things, prior approval of its EFF Rule, which amended its existing EFRP rule to permit a futures contract to serve as the related position in such transactions. The ELX EFF Rule does not explicitly establish a legitimate means to liquidate the futures positions held at another clearing house or to establish new positions at another clearing house because, among other things, it assumes the execution of a transaction on one leg that is impermissible under the rules of the other contract market and the transaction contemplated on the other leg is contingent upon the execution of a transaction that cannot be effectuated. In relevant part, ELX's EFF Rule provides:

> **IV-15 Exchange of Futures for Related Positions**
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> (a) The following transactions may be executed outside of the ELX System in all Futures in accordance with the requirements of this Rule.
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> **********
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> (iv) *Exchange of Futures for, or in connection with, futures transactions (Exchange for Futures Transactions" or "EFFs").*
> (v) For purposes of this Rule, all EFPs, EFSs, EFFs and EFRs shall be referred to as Exchanges of Futures for Related Positions.
>
> (b) The Related Position (cash, swap, futures or OTC derivative) must involve the commodity underlying the Future, or must be a derivative by-product or related product of such commodity that has a reasonable degree of price correlation or other significant price relationship to the commodity underlying the Future.
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> (c) An Exchange of Futures for a Related Position consists of *two discrete, but related simultaneous transactions*. One party must be the buyer of (or have the long market exposure associated with) the Related Position and the seller of the corresponding Future, and the other party must be the seller of (or have the short market exposure associated with) the Related Position and the buyer of the corresponding Future. However, a Participant may facilitate, as principal, an Exchange of Futures for a related Position on behalf of a Customer, provided that the Participant can demonstrate that the Futures Position or Related Position as the case may be, was passed through to the Customer.

Exchange for Risk ("EFR") – A privately negotiated and simultaneous exchange of an Exchange futures position for a corresponding OTC swap or other OTC instrument.
Exchange of Options for Options ("EOO") – A privately negotiated and simultaneous exchange of an Exchange option position for a corresponding OTC option position or other OTC instrument with similar characteristics.

For purposes of this rule, an EFP, EFR or EOO shall be referred to as an Exchange for Related Position ("EFRP").

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538.B. Related Positions
The related position (cash, OTC swap, OTC option, or other OTC derivative) must involve the commodity underlying the Exchange contract, or must be a derivative, by-product, or related product of such commodity that has a reasonable degree of price correlation to the commodity underlying the Exchange contract.

> (d) The accounts involved on each side of an Exchange of Futures for a Related Position: (i) must have different Beneficial Ownership; and (ii) must be under separate control; or (iii) must involve separate legal entities.
>
> (e) The quantity covered by the Related Position must be approximately equivalent to the quantity covered by the Futures.
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> (f) Exchanges of Futures for Related Positions may be entered into in accordance with the applicable trading increments for the Future involved, at such prices as are mutually agreed upon by the two parties to the transaction. (emphasis added.)

In its Rule Filing, ELX states that the purpose of its proposed rule "is to enable market participants to establish positions in futures contracts on ELX and liquidate such positions on another designated contract market ("DCM") that lists an *identical contract*, or to establish a position on such other DCM and liquidate it on ELX." (Rule Filing at 1 (emphasis added).) In addition to seeking approval of the Rule, ELX specifically asks the Commission to "use the powers granted to it to order an amendment to CBOT Rule 538 in order to give effect" to the ELX Rule Proposal. (Id. at 2.) This request is a clear admission that the ELX Rule cannot be used to force CBOT to transfer positions based on a notice or submission of an impermissible trade. The Commission neither affirmatively granted ELX's request for prior approval nor took any action to compel CBOT to modify CBOT Rule 538. ELX's proposed EFF rule, however, was "approved" by virtue of the fact that the Commission chose not to take action within the statutory timeframe, which expired on October 5, 2009.

As ELX concedes in its Rule Filing, CBOT rules do not permit EFFs.[8] The only arguable means by which the transactions contemplated by the EFF Rule could be effectuated on CBOT is by block trade. ELX's EFF Rule neither requires nor permits the use of matching, prearranged block trades that negate market risk to liquidate positions in one clearing house and reestablish those same positions at another clearing house. Rather, it provides:

> An Exchange of Futures for a Related Position consists of two discrete, but related simultaneous transactions. One party must be the buyer of (or have the long market exposure associated with) the Related Position and the seller of the corresponding Future, and the other party must be the seller of (or have the short market exposure associated with) the Related Position and the buyer of the corresponding Future.

Nowhere in the proposed rule itself or the explanation provided to the Commission in support of the EFF Rule does ELX explain how the related futures position may be bought or sold pursuant to CBOT's rule, nor does the Rule Filing purport to control or alter the rules of the exchange at which the related futures position was established and where it is part and parcel of the open interest.[9] Instead, ELX's Rule Filing

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[8] Moreover, an attempted EFF would be rejected by CBOT's clearing system as it does not recognize such trades.

[9] ELX's EFF Rule does not purport to provide a legitimate mechanism for the extinguishment of open interest at another clearing house. The rule can control only the creation or liquidation of open interest on its exchange and at its clearing house. The legitimate mechanism to transfer CBOT open interest to ELX is for the party who is short a CBOT contract to close that position by buying-in its short and reestablishing its short position by means of a lawful transaction at ELX. A party who is long the CBOT contract may close that position by selling its position and may reestablish that position by going long at ELX. Provided that the trades at CBOT occur in the open, competitive market, or as *legitimate* privately negotiated transactions

evidences ELX's recognition that the only way the transaction contemplated by its EFF Rule legitimately could be effectuated was if the Commission had the authority to and did force CBOT to adopt ELX's new non-competitive trading rule.

In the absence of a ruling from the Commission stating that CBOT must adopt ELX's EFF Rule – an omission which denied ELX's request for the Commission to amend CBOT Rule 538 – ELX embarked on an aggressive publicity campaign purporting to interpret CBOT Rule 538. For example, on October 14, 2009, ELX issued a press release stating that the Commission's approval of the EFF Rule gives "traders the ability to move positions between clearinghouses." ELX's admission in its application suggests that this statement was knowingly false. On that same day, ELX issued its Memo to Market stating "[a]n ELX U.S. Treasury futures contract that is executed off-exchange as part of an EFF satisfies the 'other OTC derivative' requirement" of CBOT Rule 538. (*See* ELX Memo to Market.) ELX further states in its Memo to Market that there is "no open issue of a regulatory offense for which another exchange can use its rule enforcement powers should market participants" attempt to trade on another exchange pursuant to ELX's EFF rule. (Id.) Moreover, ELX neither submitted its Memo to Market to the Commission for approval nor self-certified it, as required by the Commission. The claim that CBOT is obligated by ELX's EFF Rule to accept a non-competitive trade that is not permitted by CBOT rules is not supported by the terms of the CEA, by any rule or regulation of the Commission or by the terms of the ELX EFF rule.

In response to ELX's erroneous statements regarding CBOT Rule 538, including the issuance of its *own* interpretation of CBOT's rule (which contradicted the statements made in its Rule Filing that CBOT Rule 538 needed to be amended in order for its EFF Rule to be "implemented"), CBOT was forced to issue the Advisory Notice at issue here, which clarified the scope of CBOT Rule 538. The plain language of CBOT Rule 538 makes clear that an EFF transaction is not a permissible EFRP transaction on CBOT. ELX affirmatively conceded this fact in its Rule Filing, fully recognizing that unlike the language added to ELX's previous EFRP rule to specifically authorize EFFs, CBOT's Rule 538 nowhere mentions the term "EFF." CBOT therefore responsibly informed market participants in the Advisory Notice that, contrary to the misinformation that had been circulated by ELX with respect to CBOT's Rule 538, EFF transactions were prohibited by the rule and the rule, by its terms, permitted *only* EFPs, EFRs and EOOs. (Advisory Notice at 1.) The Advisory Notice also noted that CBOT's rules have "*never* permitted a futures contract to be used as the related position component of an EFR transaction." (Id. (emphasis added).)

ELX asserts that its October 20, 2009, Request for Stay is based on: (1) factual errors contained in CBOT's Advisory Notice, which render it a "false certification" within the meaning of Regulation 40.6(b); and (2) an alleged violation of Core Principle 18 (Antitrust Matters). Although we respond to ELX's allegations in more detail below in response to the specific questions posed by the Commission, we note that ELX can compete effectively without a CFTC order forcing CBOT and CME Clearing to close out open positions without any legitimate trade. ELX has established open interest, a relatively tight bid/offer spread and depth at the inside market. Any person or entity holding CBOT positions can liquidate its CBOT positions and establish ELX positions using the respective electronic systems of each market. In

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executed consistent with CBOT rules, CBOT has no further interest in any subsequent transaction that does not take place through the use of its facilities.

addition, since most of the open interest is in the front month, it rolls each quarter, and parties are free to roll their positions from CBOT to ELX by means of legitimate transactions. ELX's complaint regarding the Advisory Notice and CBOT Rule 538 is based on a willful misreading of the Advisory Notice and the certification, and on a misconstruction of the antitrust definitions and concepts embodied in Core Principle 18.

On October 30, 2009, the Commission sent a letter to CBOT requesting information pursuant to Commission Regulations 38.5(b) and 38.5(c) regarding the Advisory Notice and posed five specific questions to CBOT. The Commission noted that it requested information from CBOT because CBOT Rule 538 permits some EFRPs. CBOT responded to the Commission's request in its November 16 Submission.

On November 12, 2009, ELX submitted a "supplemental filing" to the Commission related to ELX's Request for Stay. In this filing (which does not appear to have been solicited by the Commission), ELX highlights for the Commission the transactions allegedly permitted on NYMEX that ELX believes are equivalent to the transactions contemplated by the ELX EFF Rule. Even assuming that NYMEX rules are relevant to the matter presently before the Commission (which they are not), as discussed in detail in Section III *infra*, ELX's assertion in this regard is simply incorrect.

In a letter dated January 4, 2010 (the "January 4 Letter"), ELX again requests that the Commission take action to "implement" the EFF Rule. In this letter, ELX states that the Commission's failure to take action to disapprove the EFF Rule meant that the Commission "determined that the Rule, and transactions executed pursuant to the Rule, would not be in violation of the CEA." (Letter from ELX to Commission dated January 4, 2010 at 2-3, the "Jan. 4, Letter," attached hereto as exhibit D.) As discussed in more detail herein, the Commission did not make such a determination. In fact, the Commission could not have made such a determination because ELX did not explain in its Rule Filing how transactions would be effectuated pursuant to the ELX Rule nor did it otherwise submit a record to the Commission to support such a finding. Thus, at most, CBOT submits that by not disapproving the Rule Filing, the Commission determined that it is *possible* to effectuate a transaction pursuant to the text of the rule that results in a transfer of positions from another exchange to ELX.

ELX also makes numerous misrepresentations with respect to the Advisory Notice and Rule 538. (See id.) For example, ELX states that (i) by issuing the Advisory Notice, CBOT "intended to, and did, have a significant chilling effect that has prevented market participants from executing a single EFF" (Id. at 2); (ii) the statements in the Advisory Notice are "contrary to the Commission's action in approving the EFF Rule" (Id. at 2-3); (iii) CBOT's current rules are sufficient in their current form to accommodate the transaction contemplated by its EFF Rule (Id. at 5); and (iv) CBOT Rule 538 covers the ELX EFF because the ELX futures transaction is an "OTC swap" or "OTC derivative" within the meaning of the rule (Jan. 4 Letter at 6.) All of these statements are contradicted by ELX's Rule Filing, which reflects that ELX understood that CBOT Rule 538 did not permit the transactions contemplated by ELX's EFF Rule. To be sure, ELX specifically requested in the Rule Filing that the Commission order CBOT to amend Rule 538. If CBOT's Rule 538, in its current form, permits the transaction contemplated by ELX's EFF Rule, then ELX would not have asked the Commission to force CBOT to amend the rule to accommodate such transactions. And, if CBOT Rule 538 did not permit EFFs prior to ELX's Rule Filing, as ELX concedes in its Rule Filing, the Advisory Notice could not have been intended to have a "chilling effect" on the market

as ELX claims, but instead was intended to clarify any confusion that ELX may have caused by its inaccurate and inappropriate press release regarding the plain meaning of Rule 538.

On January 22, 2010, Staff sent a letter to CBOT stating that (i) inter-market combination trades are not *per se* unlawful and (ii) matched block trades are not *per se* unlawful and set forth the basis for its disagreement with certain statements made in CBOT's Advisory Notice (the "Staff Letter"). In connection with this letter, Staff sent a second letter to CBOT also dated January 22, 2010, requesting additional information from CBOT respecting its Advisory Notice. CBOT's responses to this request for information are set forth in Sections III-VIII below.

On January 26, 2010, ELX released a copy of the Staff Letter to the market. In conjunction with releasing the Staff Letter, ELX made inaccurate statements to the market as to the effect of the Staff Letter. Contrary to ELX's representations, the Staff Letter did not represent an official agency decision and CBOT was not required to take any action with respect to its Advisory Notice or CBOT Rule 538.

As a result of ELX's release of the Staff Letter to the market and its misrepresentations as to the impact of that letter on CBOT's Rule 538, CBOT again was forced to correct the inaccurate information disseminated to the market with a responsive press release. In its responsive press release, CBOT simply explained that the Commission had not taken any action against CBOT, that the Advisory Notice and Rule 538 still were enforceable, and that the transactions contemplated by ELX's EFF Rule were prohibited on CBOT.

On January 27, 2010, ELX again wrote the Commission in an attempt to elicit a decision from the Commission on its Request for Stay and/or other requests for relief contained in its miscellaneous filings (the "January 27 Letter"). In addition to reiterating its position as reflected in its previous communications to the Commission, the January 27 Letter requests that the Commission order a "corrective release." CBOT's press release contained no misstatements in need of correction, as CBOT is sure the Commission would agree that the Staff Letter did not represent a final agency decision.

III. The Staff's January 22, 2010 Letter to CBOT Ignores Material Facts and Long-Standing Commission Precedent

The Staff Letter states that CBOT "mischaracterized the requirements of the CEA with respect to (i) the prohibition of EFF trades and matched block trades that are executed to enable inter-exchange transfers of futures positions as *per se* wash or fictitious trades in violation of the CEA; and (ii) the prohibition of such matched block trades as impermissible contingent and transitory trades." (Jan. 22 Letter at 2.) The Staff further states that it "believes that CBOT's interpretation of its rules respecting EFFs and matched block trades cannot be justified by the Commission's regulatory precedent." (Id.) The Staff's conclusions fail to consider material facts that are both part of the Commission record and included in CBOT's November 16 Submission and ignore long-standing Commission precedent on wash and fictitious trading. Indeed, had the Staff considered all relevant facts and binding Commission precedent, we submit that it could not have concluded that CBOT mischaracterized anything in its Advisory Notice. For the reasons that follow, CBOT submits that the Staff's conclusions cannot be squared with precedent or recent enforcement action by the Commission.

As an initial matter, the Staff Letter states that the Commission found that ELX's rule complies with the CEA. However, because the Commission allowed the rule to go into effect without affirmative approval, there is no record on the issues presented by ELX's rule or considered by the Commission. Notably, ELX's submission does not explain how the contemplated EFF transactions will be effectuated.[10] At most, the Commission's apparent decision not to stay implementation of the EFF Rule can be characterized as a determination by the Commission that the EFF Rule did not, *on its face*, violate the CEA.

The Staff Letter also states that the Staff disagrees with CBOT's assertions that matched block trades and inter-market combination trades are *per se* unlawful. However, CBOT has made no such statements in its Advisory Notice or its November 16 Submission. Rather, CBOT's November 16 Submission makes clear that only *matched, prearranged block trades and EFRPs that involve no market risk* are wash trades under Commission precedent, and that it would take regulatory action against any such transaction whether made in the form of block, EFP, EFR or EFF. In fact, the following language, which has been included in several self-certified advisories over the past five years without comment from the Commission, underscores that this has been CBOT's consistent position on this issue:

> Two parties may not execute contingent EFP, EFS or EFR transactions in which the execution of one such trade is contingent upon either the execution of another EFP/EFS/EFR or another offsetting cash, swap, or OTC transaction. In cases where two parties execute an EFP, EFS or EFR and execute an economically offsetting cash, swap or OTC transaction, the participants may be required to demonstrate that there was no express or implied obligation or understanding to execute both transactions. For example, two parties are prohibited from executing contingent March and June Treasury Bond EFPs to roll a position. *Similarly, two parties are prohibited from executing a CBOT EFP and a contingent EFP on another market in which the cash transaction economically offsets the cash leg of the CBOT EFP.* Such transactions are considered prearranged futures trades that circumvent the open market execution requirement.

(CBOT Advisory Notices attached hereto as exhibit E (emphasis added).) Thus, CBOT's recent Advisory Notice, consistent with its prior actions and statements, makes no misrepresentations and is consistent with Commission precedent. Certainly, the Commission would agree that prearranged, matched trades that negate market risk are wash trades, even if they otherwise have a legitimate purpose.

The Staff Letter further states that the Staff do not believe that "matched pairs of block trades executed for the purpose of moving futures positions from one exchange to another raise any unique regulatory concerns." Accordingly, this fails to address the central focus of CBOT's Market Regulation Advisory Notice RA0907-1: that ELX's proposed EFFs are prearranged with the intent and effect of negating market risk. Indeed, CBOT cited Commission precedent in its November 16 Submission that

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[10] We also note that the Rule Filing was not posted in the section of the Commission's website where requests for comments are normally published. Contrary to ELX's suggestion that the marketplace agreed that its rule fully complied with the CEA since no comments were filed, it is more likely that no comments were submitted because market participants were unaware that the submission was pending before the Commission until *after* ELX notified the public that its EFF Rule had been "approved."

clearly establishes that where there is an intent to negate market risk, an otherwise lawful purpose for the transaction will not save a transaction from qualifying as a wash trade or fictitious transaction, even where two different markets are involved. (See Nov. 16 Letter from CBOT to CFTC at 7-10.)

Further, the Commission in a recently settled enforcement action underscores that CBOT's position on this matter is consistent with Commission precedent and current practice. *In re Pinemore, L.P. and Birchmore, L.P*. targeted market participants that executed offsetting positions in natural gas futures contracts in a manner designed to minimize "slippage," or price difference, between their various holdings. In finding these trades improper, the Commission emphasized their non-competitive and market-averse nature. *In re: Pinemore, L.P. and Birchmore, L.P*., order dated Jan. 28, 2010 attached hereto as exhibit F ("[T]he trades . . . negat[ed] the risk incident to the market and produced a virtual financial nullity"). The assertion that the transactions proposed by ELX in its press releases are not wash trades because they do not have an otherwise unlawful purpose, if adopted by the Commission, would require it to prove motive and adverse impact in wash trade cases and negate the basis for its high visibility prosecutions of energy traders.

With respect to their degree of market exposure, the trades authorized by ELX's EFFs are indistinguishable from the transactions at issue in *In re Pinemore L.P*. (arguably less so as the orders were at least ostensibly exposed to the market and price reported). Although market participants may occasionally wish to enter such null trades solely in order to shift their holdings from one exchange to another, this permissible objective does not alter the fact that any such EFF transaction would "negate market risk [and] price competition" (Exhibit F at 4.) and undermine the integrity of the market's price-discovery function.

Significantly, the Commission did not view legitimate business purposes as being sufficient to save transactions of this kind. The defendant companies in *In re Pinemore* entered into the transaction with the intent to minimize slippage as a means of pursuing an otherwise a lawful goal. The Commission assigned no importance to these facts; its sole concern was whether the trades had been undertaken with "the intent to avoid making a *bona fide* transaction or taking a *bona fide* market position." We are aware of no "unique regulatory concern" respecting the trades at issue in *In re Pinemore*, but that did not preclude an enforcement action. The Commission's rationale for the prosecution in *In re Pinemore* is clear support for CBOT's reliance on the Commission's long-standing precedent on wash trades to show that the trades contemplated by ELX's EFF Rule would in fact be wash trades and therefore violate the CEA.

In concluding that the transactions contemplated by ELX's EFF rule do not "raise any unique regulatory concerns," the Staff appears to rely exclusively on the Commission's approval of an EFF rule submitted by NYMEX in early 2002 and approved by the Commission later that year on a trial basis. Although the NYMEX EFF rule and ELX's EFF Rule have the term "EFF" in the title, as explained in CBOT's November 16 Submission, the rules are easily distinguishable. As explained in CBOT's November 16 Submission, there are genuine, material differences between the NYMEX Rule and ELX's EFF Rule.[11] The NYMEX Rule was, in substance, a restricted block trading rule that included information-

[11] *See* New York Mercantile Exchange, Inc., CFTC Rule Approval Notice (May 3, 2002), *available at* http://www.cftc.gov/files/foia/comment02/foicf0203b002.pdf.

reporting requirements analogous to those contained in EFRP rules. (NYMEX EFF Rule, attached hereto as exhibit G.) In fact, at the time that the NYMEX EFF rule was submitted to the Commission for approval, neither NYMEX nor International Petroleum Exchange ("IPE") had block trading rules governing Brent Crude Oil futures contracts.

Significantly, the NYMEX Rule did not seek to bind other contract markets. The NYMEX Rule explicitly provided that a market participant seeking to take advantage of the rule needed to liquidate its position on the other contract market pursuant to the rules of *that* contract market. The NYMEX Rule provided: "As a condition precedent to the NYMEX Transaction, the parties to the NYMEX Transaction *must have engaged in a transaction on the other regulated futures exchange pursuant to the procedures of such other exchange that resulted in liquidating an existing position at such other exchange*." (*See* NYMEX Rule, subsection (2), (emphasis added).) The Staff do not appear to have considered these facts in issuing the January 22 Letter.[12]

CBOT submits that the following facts further support its position that the Commission's approval of the NYMEX EFF rule is not binding precedent in this instant situation: (i) the IPE issued a market advisory notice similar to CBOT's Advisory Notice stating that IPE did not allow EFFs;[13] (ii) the NYMEX EFF rule was approved only as part of a one-year pilot program; (iii) the rule was never implemented; no transaction was ever effectuated pursuant to the rule; and (iv) it was withdrawn from a proposed rule filing in 2004 pursuant to the Commission's request.

The Staff's conclusions also assume that ELX's proposed EFF transaction involves market risk which is necessary in order to have a *bona fide* transaction. However, the Staff only argues that the EFF contemplated by ELX's rule may involve some theoretical, unquantifiable change in *counterparty* risk. There is no acceptance of *market risk* is involved, and every wash trade case with which we are familiar arises from the lack of market risk. The CBOT Treasury futures contracts and the corollary ELX Treasury futures contracts are the *same* futures contracts; in fact, ELX states in its Rule Filing that the contracts are "identical." (Rule Filing at 1.) ELX's goal is to move a long and short position between two clearing houses without the assumption of any market risk. There is no real transaction between the parties except an agreement to move open interest. This illustrates the very definition of a fictitious, wash trade under Commission precedent. The EFP and EFS transactions permitted on CBOT are clearly distinguishable; such transactions involve clear market risk arising from the basis risk. *See, e.g., In re CIC Banque Credit Industriel D'Alsace et de Lorraine Societe Anonyme*, [2007-2009 Transfer Binder] Comm. Fut. L. Rep. (CCH) 30,675 (CFTC Sept. 27, 2007) ("Negated risk is not 'the equivalent of no risk or the complete elimination of risk'; rather the Commission has clearly held that risk is negated whenever it is 'reduced to a level that has no practical impact on the transactions at issue.'") (citation omitted).

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[12] Additionally, the NYMEX Rule provided that the minimum transaction size for effectuating trades pursuant to the rule was 50 contracts, which, at the time, exceeded in size more than 90% of the transactions that had been executed in the months before NYMEX sought approval for the rule in the contract at issue. Moreover, only "eligible contract participants," as defined in the CEA, could take advantage of the new procedure set forth in the NYMEX Rule. (Id.) Finally, the two transactions were independent of each other and did not necessarily involve the same parties. None of these requirements is present in ELX's EFF Rule.

[13] IPE Statement to Market, attached hereto as exhibit H.

To accept the rationale offered by ELX in its January 4 Letter to the Commission – namely, that market risk and counterparty risk are indistinguishable – as the Staff appear to have done, would require the Commission to permit two traders with massive opposite positions at CBOT to do a block trade, which substitutes counterparty risk for CCP risk, on day one to eliminate the positions and disrupt the market as the open interest disappeared and, by prearrangement, reverse the block trade the next day to restore the positions and eliminate counterparty risk and reinsert the CCP. Such a transaction would not be a wash trade under the rationale set forth in the Staff Letter because the counterparty risk changed each time a block was completed, if only for a day. In other words, the switch from clearinghouse to counterparty risk is exactly the same under the Staff's rationale as the switch from clearinghouse A to clearinghouse B.

For all these reasons, and the reasons discussed below, we submit that the conclusions of the Staff in its January 22 Letter are neither supported by nor consistent with Commission precedent.

IV. Legal and Economic Principles Justify Distinguishing Between EFFs and EFPs, EFRs and EOOs

Commission Regulation 1.38 ("Regulation 1.38") provides, in relevant part:

> (a) *Competitive execution required; exceptions.* All purchases and sales of any commodity for future delivery, and of any commodity option, on or subject to the rules of a contract market shall be executed openly and competitively by open outcry or posting of bids and offers or by other equally open and competitive methods, in the trading pit or ring or similar place provided by the contract market, during the regular hours prescribed by the contract market for trading in such commodity or commodity option: *Provided, however,* That this requirement shall not apply to transactions which are executed non-competitively in accordance with written rules of *the contract market* which have been submitted to and approved by the Commission, specifically providing for the non-competitive execution of such transactions. (emphasis added.)

Commission Regulation 1.38 generally requires that all purchases and sales of a futures contract or an options contract on a futures contract should be executed by open and competitive methods. However, transactions may be executed in a "non-competitive" manner if executed pursuant to exchange rules specifically providing for the non-competitive execution of such transactions, provided such rules were approved by the Commission. The plain language of Regulation 1.38 makes clear that each *individual* contract market is granted discretion to permit non-competitive trading pursuant to *its* written rules for *its own* markets, subject to Commission approval.[14] There is nothing in Regulation 1.38 that can

[14] "To determine a law's plain meaning, we begin with the language of the statute. If the language of the statute expresses ... intent with sufficient precision, the inquiry ends there. *United States v. Gregg*, 226 F.3d 253, 257 (3d Cir. 2000) (citations omitted). We take the same approach to interpreting Commission regulations." *See, e.g.*, *In re New York Currency Research Corp.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) P 27,222 at 45,908-11 (ALJ Jan. 12, 1998), rev'd, *In re New York Currency Research Corp.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) P 27,223 (CFTC Feb. 6, 1998), modified on reconsideration, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) P 27,311 (CFTC March 31, 1998), rev'd, New York Currency Research Corp. v. CFTC, 180 F.3d 83 (2d Cir. 1999). *In re Prudential Securities, et al*., [2002-2003 Transfer Binder] Comm. Fut. L. Rep. (CCH) P 29,090 (CCH) P 29,090.

be construed to support ELX's contention that a non-competitive trading rule adopted by contract market A and approved by the Commission is binding on contract markets B, C, and D or that those contract markets must themselves adopt and submit for approval the exact non-competitive trading rules of contract market A.[15] It is well established that an exchange may, and should have different non-competitive trading rules for its various contracts depending on market need and the legitimate expectations of its customers. There is also no provision in the CEA that could be construed to achieve such a result.

As explained in CBOT's November 16 Submission, if a designated contract market chooses to permit non-competitive trades, it has the right to enact rules that permit trades that are in the best interests of preserving transparency and liquidity on its markets. Nonetheless, futures exchanges also must balance any such non-competitive rules with Core Principle 9 (Execution of Transactions) applicable to futures exchanges, which mandates that "[t]he board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions." The Staff position fails to recognize these rights and obligations and adoption of the Staff's position by the Commission would undermine the very purpose of Congressional intent in requiring open and competitive markets that foster price discovery.

In the fall of 2008, the Commission issued a request for comment on its proposed guidance for Core Principle 9 and on certain proposed amendments for Regulation 1.38. In that Federal Register release, the Commission opined that the "implicit assumption" in Regulation 1.38 was that "trading should take place on the centralized market unless there is a compelling reason to allow certain transactions to take place off the centralized market."[16] The Commission further noted that exchange rules and policies allowing such transactions:

> [S]hould ensure that the impact on the centralized market is kept to a minimum. For example, certain types of off-centralized market transactions, such as block trades and exchanges of futures for related positions, can create new positions or reduce prior positions. If these transactions become the exclusive or predominant method of establishing or offsetting positions in a particular market, it might jeopardize the centralized market's role in price discovery and would not comply with Core Principle 9, which provides that trading be competitive, open and efficient. (Id.)

While the Staff Letter references this request for comment, it does not address the foregoing excerpts from it. Thus, CBOT assumes that the Staff does not disagree with the Commission's statements that contract markets should ensure that trading take place "on the centralized market unless there is a *compelling reason* to allow certain transactions to take place off the centralized market." (Id.(emphasis added).) As explained in its November 16 Submission, CBOT has concluded that there is no reason – let

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15 CBOT notes that if the Commission were to improperly force CBOT to amend its rules to permit non-competitive trades in the form of an EFF, as ELX requests, such action would effectively allow parties to circumvent CBOT's block trading rule because ELX's block trading thresholds are substantially lower than CBOT's. Parties would be permitted to execute block trades on ELX at the lower threshold and then simply transfer the position to CBOT via an EFF, completely undermining the CBOT's block trading rule.

16 *See* Execution of Transactions: Regulation 1.38 and Guidance on Core Principle 9, 73 Fed. Reg. 54097, 54099 (Sept. 18, 2008).

alone a "compelling reason" – to permit EFF transactions in its markets. On the contrary, CBOT determined, long before the ELX adopted and submitted its EFF rule, that liquidity and transparency are best preserved if EFFs were not permitted.

The Staff also does not dispute CBOT's recitation of the application guidance for Core Principle 9 in its November 16 Submission. Core Principle 9 provides that a "competitive, open and efficient market and mechanism for executing transactions includes a board of trade's methodology for entering orders and executing transactions" and that "a designated contract market that determines to allow block trading should ensure that the block trading does not operate in a manner that compromises the integrity of prices or price discovery on the relevant market." Thus, we assume that Staff does not disagree that this principle is applicable to CBOT's decisions respecting non-competitive trades, including the EFF contemplated by ELX's Rule Filing.

Moreover, in the Order issued by the Commission just last week in the *Scotia Capital Inc.* matter, the Commission reiterated that non-competitive trades that give the appearance of submitting trades to the open market while negating the market risk or price competition incident to such a market violate Section 4c(a) and Regulation 1.38(a). (See *In re Pinemore* at 3-4.) With respect to the violation of Regulation 1.38(a), the Commission explained:

> Regulation 1.38(a) requires that all purchases and sales of commodity futures be executed "open and competitively." The purpose of this requirement is to ensure that all trades are executed at competitive prices and directed into a centralized marketplace to participate in the competitive determination of the price of futures contracts. Noncompetitive trades are generally transacted in accordance with express or implied agreements or understandings among the traders. *Gilchrist*, ¶ 24,993 at 37, 652. Noncompetitive trades are also a type of fictitious sale, because they negate the risk incidental to an open and competitive market. *Fisher*, ¶ 29,725 at 56,052 n.11. Trades can be noncompetitive even though they were executed in the pit. *In re Buckwalter*, [1990-1992 Transfer Binder] Comm. Fut. L. rep. (CCH) ¶ 24, 995 at 37,683 (CFTC Jan. 25, 1991) (*citing Laiken v. Dep't of Agriculture*, 345 F.2d 784, 765 (2d Cir. 1965)). Prearranged trading is a form of ant-competitive trading that violates Commission Regulation 1.38(a). *Gimbel*, ¶ 24,213 at 35,003; *In re Shell Trading US Co.*, CFTC Dkt. 06-02 (Jan. 4, 2006).

(Id. at 4.)

As CBOT explained in its November 16 Submission, the Treasury complex at both CBOT and ELX are liquid markets and there is no legitimate reason to permit a non-competitive transaction without any economic substance that will cause sudden, inexplicable changes in open interest. Any trader with a position at CBOT in a Treasury contract can quickly and easily exit that position and reestablish it at ELX by simultaneously buying and selling at the respective exchanges on their electronic systems. Indeed, our records indicate that CBOT has, at all relevant times, had narrow spreads and substantial size bid and offered at the inside market. It is our understanding that ELX offers similarly narrow spreads and ELX reported record volume in October 2009. In fact, it recently reported being the best performing new financial futures exchange launched this past decade: "ELX Futures, L.P. (ELX Futures) announced today

its 2009 year-end results with total volume exceeding 5 million contracts; average daily volume surpassing 41 thousand contracts; open interest topping 20 thousand contracts and ELX becoming the best performing new financial futures exchange launched this past decade."[17] If the size of the position to be moved is "too big" for the competitive market, a customer may enter into a block trade to liquidate its CBOT position and enter into a *separate and independent* block trade to establish an ELX position. In fact, ELX's block trading thresholds during regular trading hours are at least 80% smaller than the CBOT's block trading thresholds. While block trades may detract from the benefits derived from bringing all transactions to the competitive arena, they are tolerated, subject to clear limits and strict measures to assure a significant measure of transparency and fairness to other market participants, as mandated by the rules established by CBOT and the Commission. CBOT does not believe it is in the interest of its market or of its customers to offer holders of open interest the opportunity to eliminate their positions and impact liquidity and effective spreads without any legitimate trade.

If the transaction required to effectuate an EFF begins or ends with a legitimate competitive transaction at CBOT, CBOT does not have a direct regulatory interest. ELX, however, is promoting an entirely different means to accomplish the liquidation of open positions at CBOT and the reestablishment of those positions at ELX. ELX expects to authorize its members to enter into a matched pair of transactions that involve no market risk and no change of position and to then send a note to CBOT and its clearing house announcing that 5,000, 10,000, or even 100,000 open Treasury positions have been liquidated. From the standpoint of market participants, permitting such action would adversely impact liquidity and effective spreads without any legitimate trade.

EFRP transactions at CBOT have traditionally been executed to preserve basis relationships and mitigate the execution risk associated with the initiation or liquidation of a futures or futures option position to hedge a physical or OTC position, and have fostered the use of transparent exchange markets as a price source for transactions in the physical and OTC markets. In the case of certain EFRPs, the mechanism has facilitated clearing for the OTC market, thereby allowing for the mitigation of counterparty and systemic risk and enhanced transparency. Contrary to ELX's assertion that an ELX futures contract represents an OTC instrument that qualifies under CBOT Rule 538 as the OTC component of a CBOT EFRP transaction, it clearly is not an OTC instrument but an identical futures contract as explained above.

If prearranged, matching pairs of offsetting EFP, EFR, EOO or block transactions are executed without incurring market risk, CBOT's prohibitions on wash sales and fictitious trading would be violated. The fact that the prearranged and matching pair of transactions involves trades on CBOT and another exchange does not obviate the requirement that the CBOT trade be bona fide. CBOT reiterates that in our view such trades are fictitious or wash trades, which, consistent with Commission precedent, are prohibited by CBOT Rules.[18] CBOT restates and incorporates herein the

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[17] *See* http://www.elxfutures.com/News-Events/ELX-Futures-Announces-2009-Results.aspx.

[18] Rule 534. Wash Trades Prohibited

No person shall place or accept buy and sell orders in the same product and expiration month, and, for a put or call option, the same strike price, where the person knows or reasonably should know that the purpose of the orders is to avoid taking a bona fide market position exposed to market risk (transactions commonly known or referred to as wash sales). Buy and sell orders for different accounts with common beneficial

wash and fictitious trading discussion from its November 16 Submission in its entirety because the Staff failed to distinguish the precedent cited therein from the facts presented by the transactions at issue here or to otherwise provide citation to Commission precedent overruling the authorities cited by CBOT. (Nov. 6 Letter at 7-10.)

CBOT rules permit a firm or customer to establish or liquidate a position by means of a legitimate trade. CBOT rules require, consistent with the CEA, that the trade be a bona fide trade rather than a fictitious trade. CBOT's interpretation of its rules, consistent with CFTC precedent, makes clear that a prearranged, matched pair of trades executed for the purpose of moving a futures position from one clearing house to another involves both contingent and transitory trades that are fictitious rather than bona fide and consequently violate CBOT rules. The Advisory Notice did not change CBOT Rules.

V. The Advisory Notice and CBOT Rule 538 Comply With Core Principle 18

As an initial matter, ELX knew when it requested Commission approval of its EFF Rule that CBOT Rule 538 did not permit EFF transactions. ELX specifically requested in its Rule Filing – which predated the Advisory Notice by more than three months – that the Commission order CBOT to amend its Rule 538 to allow the EFF transactions contemplated by ELX's EFF Rule. With respect to the Advisory Notice, as previously explained, the only reason CBOT issued the notice was to correct the false information that ELX disseminated to the market regarding CBOT Rule 538. This chronology of events belies ELX's claim of ill motive or anti-competitive effects by CBOT.

Even in the absence of the foregoing chronology, both the Advisory Notice and CBOT Rule 538 comply with Core Principle 18. Core Principle 18 specifically invokes the "antitrust" law in its title and provides:

> "***Antitrust Considerations*** –
>
> Unless necessary or appropriate to achieve the purposes of this chapter, the board of trade shall endeavor to avoid:
>
> (A) adopting any rules or taking any actions that result in any unreasonable restraints of trade; or
>
> (B) imposing any material anticompetitive burden on trading on the contract market." (emphasis added.)

Indeed, the plain language of Core Principle 18 makes clear that where a contract market takes appropriate action to achieve the purposes of the CEA, the contract market's actions are not evaluated for antitrust concerns. As previously noted, one of the explicit purposes of the CEA is to prevent fictitious and wash trading. *See* CEA §4c(a) (prohibiting wash trades, accommodation trades and fictitious trades). The CEA also forbids the reporting of prices that are not bona fide. For the reasons discussed in response to the Commission's first question, we believe that the EFF transaction contemplated by ELX, or prearranged matched pairs of block trades, would constitute wash and

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ownership that are entered with the intent to negate market risk or price competition shall also be deemed to violate the prohibition on wash trades. Additionally, no person shall knowingly execute or accommodate the execution of such orders by direct or indirect means.

fictitious trades under both CBOT rules and the CEA. Thus, CBOT's Advisory Notice setting forth its interpretation of its existing rule prohibiting conduct forbidden by the CEA is fully consistent with CBOT's obligation to take affirmative steps to prevent violations of the CEA involving the reporting of wash and fictitious transactions and fictitious prices. It is also consistent with Commission precedent insofar as similar market advisory notices have been issued by contract markets in the past without disapproval from the Commission. *See, e.g.,* Rule 432.D Interpretation, dated July 9, 2004, and Special Executive Report S-4735, dated July 21, 2008. For this reason, the Advisory Notice (and CBOT Rule 538) is exempt from any limitation in subparagraph A of Core Principle 18.[19]

The Advisory Notice (and CBOT Rule 538) is further exempt from any limitation in subparagraph A of Core Principle 18 because it is appropriate to achieve another purpose of the CEA – ensuring that trading on the contract market be competitive, open and efficient. (*See* Core Principle 9.) Regardless of whether the Commission agrees with CBOT that the transactions contemplated by the ELX EFF Rule constitute wash and/or fictitious trades within the meaning of the CEA, CBOT has concluded that the transactions contemplated by the ELX EFF Rule would detract from a competitive, open and efficient market in Treasury futures traded on the CBOT. As explained in response to the Commission's first question, the Treasury complex at both CBOT and ELX are liquid markets and there is no legitimate reason to permit a non-competitive transaction without any economic substance that will cause sudden, inexplicable changes in open interest. ELX's statement in its January 4 Letter to the Commission that "[a]nother exchange cannot eviscerate [the Commission's approval of the EFF Rule] . . . by substituting its own conclusions for those of the Commission" (Jan. 4 Letter at 5) intentionally overlooks the fact each exchange is tasked with the responsibility of deciding the types of non-competitive trades that may be permitted in the best interests of preserving transparency and liquidity in its markets; if each exchange decides that permitting a certain non-competitive trade is in fact in the best interests of preserving transparency and liquidity in its markets, it must seek Commission approval before allowing such transactions to be effectuated. However, there is nothing in the CEA or the Commission's rules or regulations that require contract market A to adopt the non-competitive trading rules of contract market B.

Even assuming, however, that the Advisory Notice and CBOT Rule 538 are neither a necessary nor appropriate means for carrying out the foregoing purposes of the CEA (which they are), they still comply with Core Principle 18 because they do not constitute unreasonable restraints on trade. Without an "unreasonable restraint of trade," there can be no violation of Core Principle 18. Although there is no Commission precedent explicitly interpreting Core Principle 18, it cannot seriously be disputed that Core Principle 18's terms (the phrase "unreasonable restraint of trade" in particular) are derived from antitrust law. *See* 1 PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, DERIVATIVES REGULATION §2.12[1] (Aspen Publishers 2004) (discussing legislative history of CEA Section 15, the predecessor to Core Principle 18). Indeed, as one leading scholar explained, with the amendment of the CEA by the CFMA in 2000:

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[19] Subparagraph (B) is not applicable here. It pertains to a rule of a board of trade that imposes anticompetitive burdens on the participants trading on the contract market that adopts the rule. Note that it does not refer to trading on "another contract market." The actual clause pertains to restrictions "on trading on *the* contract market" (emphasis added.) This clause was intended to prevent an exchange from discriminating among its own members in respect of trading on its markets.

> [S]ection 15 was reduced to a duty of the Commission to consider the antitrust laws and to endeavor to take the least anticompetitive means in adopting its own rules, regulations and orders. The obligation of the exchanges to do so in relation to its own rules and regulations was uncoupled and now appears as a 'core principle' in sections 5 and 5a of the Act.

Id. at 613.

Although the phrase "unreasonable restraint of trade" does not appear in the text of the Sherman Act, it is a term of art that was established by early Supreme Court cases interpreting that statute's text. In *Standard Oil Co. of N.J. v. United States*, the Supreme Court ruled that the Sherman Act's broad prohibition of "restraint[s] of trade" in 15 U.S.C. §1 was limited by an implicit "rule of reason." 221 U.S. 1, 66 (1911) ("[T]he construction which we have deduced from the history of the act and the analysis of its text is simply that in every case where it is claimed that an act or acts are in violation of the statute, the rule of reason, in the light of the principles of law and the public policy which the act embodies, must be applied."). The phrase "unreasonable restraint" was first used by the Supreme Court in the antitrust context only a year later in *United States v. Terminal Railroad Association of St. Louis*, 224 U.S. 383, 394-95 (1912). It has since become a core term of antitrust analysis. *See, e.g.,* Oksanen v. Page Mem'l Hosp., 945 F. 2d 696, 702 (4th Cir. 1991) ("To prove a violation of section one of the Sherman Act . . . a plaintiff must show the existence of an agreement . . . that imposes an unreasonable restraint of trade."); *Telerate Sys., Inc. v. Caro*, 689 F. Supp. 221, 235 (S.D.N.Y. 1988) ("[N]ot every refusal separately to sell two products is a restraint of trade. Only those refusals to sell products separately that impose an unreasonable restraint of trade."). "[W]hen 'judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its . . . judicial interpretations as well.'" *United States v. Hayes*, 129 S. Ct. 1079, 1086 (2009) *quoting Bragdon v. Abbott*, 524 U.S. 624, 645 (1998); *see also Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 85-86 (2006) ("Congress can hardly have been unaware of the broad construction adopted by both this Court and the SEC when it imported the key phrase – 'in connection with the purchase or sale' - into SLUSA's core provision. And when 'judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its . . . judicial interpretations as well.'") (citations omitted).

Although ELX had originally invoked an antitrust case to support its claim, it now asserts that a violation of Core Principle 18 can be found where there is no "unreasonable restraint of trade," (Jan. 27, Letter) but ELX does not − because it cannot − provide any authority to support its conclusory assertion that something other than antitrust principles define "unreasonable restraint of trade." There is no authority to support ELX's contention that CEA Section 3(b) can be used by the CFTC to force CBOT to amend its non-competitive trading rules to conform those of ELX in the absence of a finding that CBOT Rule 538 violates Core Principle 18. (Id. at 8.)[20]

Moreover, in its January 4 Letter to the Commission, ELX asserts that "[b]y blocking the implementation of the EFF Rule through the Advisory [Notice] the CBOT . . . [has] used [its] market

[20] Moreover, contrary to ELX's assertion, Section 6b of the CEA does not apply in this instance. The Commission has issued no order finding that CBOT Rule 538 violates Core Principle 18 or that regulation 1.38 requires that contract market A must adopt the non-competitive trading rules of contract market B. Such an order would conflict with the plain language of the CEA and the Commission's regulations.

dominance for anticompetitive purposes to deny market participants the advantages of this important tool, in violation of the CEA." (Jan. 4 Letter at 8.) This statement is not based in fact. Indeed, nothing in CBOT's Advisory Notice precludes any person from trading Treasury contracts at ELX or clearing those trades at the OCC. As discussed in CBOT's November 16 Submission, no CBOT rule prevents CBOT customers from closing open positions at CBOT in accordance with CBOT's rules and reestablishing them at ELX:

> Any trader with a position at CBOT in a Treasury contract can quickly and easily exit that position and reestablish it at ELX by simultaneously buying and selling at the respective exchanges on their electronic systems. Indeed, our records indicate that CBOT has, at all relevant times respecting such transactions, had narrow spreads and substantial size bid and offered at the inside market. It is our understanding that ELX offers similarly narrow spreads and reported record volume in October 2009. If the size of the position to be moved is "too big" for the competitive market, a customer may enter into a block trade to liquidate its CBOT position and enter into a *separate and independent* block trade to establish an ELX position. In fact, ELX's block trading thresholds during regular trading hours are at least 80% smaller than the CBOT's block trading thresholds.

(Nov. 16 Submission at 6-7.) Moreover, as evidenced by its express request in its Rule Filing for the Commission to order CBOT to amend Rule 538, ELX knew that EFFs were not permitted on CBOT prior to submitting the Rule Filing and subsequently purporting to interpret the rule for the market. The Advisory Notice did not alter the scope of permissible trades under CBOT Rule 538 or otherwise block the "implementation" of the EFF Rule.

Stripped of its conclusory assertion that the Advisory Notice "unreasonably restrains" trade, it is evident that ELX's real complaint is that the mechanisms available under CBOT's rule for transferring positions from CBOT to ELX – which are the same mechanisms that were available before the issuance of the Advisory Notice – are less than ideal for ELX's business model. While there is no Commission precedent explicitly interpreting Core Principle 18, as noted above, it is well-established antitrust law that mere disadvantage to a competitor is not an "unreasonable restraint of trade." In fact, as discussed in CBOT's November 16 Submission, Supreme Court precedent emphasizes that, except in limited circumstances not applicable here, there is no duty for an enterprise to assist its rivals. *See Verizon Commc'ns, Inc. v. Law Offices of Curtis V. Trinko, LLP,* 540 U.S. 398, 411 (2004).

The legal principle enunciated in *Trinko* has been reaffirmed by the Supreme Court and the Court of Appeals for the Tenth Circuit in recent months. Specifically, on February 25, 2009, the Supreme Court, in *Pacific Bell Telephone Co. v. Linkline Communications, Inc*., unanimously reversed the Ninth Circuit and held that a price-squeeze claim may not be brought under Section 2 of the Sherman Act when the defendant has no antitrust duty to deal with its rivals. The decision expands the scope of the Supreme Court's decision in *Trinko* and further limits a dominant firm's obligations to its rivals. *Linkline* not only refused to find the defendant at fault for having engaged in price-squeezing, but also stated that a defendant would be acting within its rights if it chose to exploit its dominant position in the digital subscriber line (DSL) services market by charging more for wholesale use of its essential DSL facilities than it did for retail use. *Id.* at 1122. On September 29, 2009, the Tenth Circuit in *Four Corners Nephrology Associates, PC v. Mercy Medical Center of Durango*, held that a hospital's refusal to allow a

physician access to its nephrology facilities does not constitute anticompetitive conduct under Section 2 of the Sherman Act. 582 F.3d 1216 (10th Cir. 2009). The Court, citing *Trinko* and *Linkline*, affirmed that the general rule is that a business – even a putative monopolist – has no antitrust duty to deal with its rivals. *See id.* at 1221.

In its January 4 Letter, ELX attempts to undermine *Trinko* as controlling precedent by relying on *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.,* which is cited in *Trinko*, to support its contention that CBOT acted in an anticompetitive manner in violation of Core Principle 18 by issuing the Advisory Notice. Contrary to ELX's representations, *Aspen* is inapposite and does not support its claim. *See Aspen Skiing Co. v. Aspen Highlands Skiing Corp.,* 472 U.S. 585 (1982). In *Aspen*, the competitors had a long-standing and profitable business relationship. The entities previously offered skiers an "all-Aspen" ski pass that could be redeemed at either entity's ski resort(s). Aspen Skiing owned three ski resorts, while Aspen Highlands owned only one. Aspen Highlands terminated its participation in the "all-Aspen ski pass" in favor of a ski pass that allowed skiers access to only its resorts. Although Aspen Highlands was willing to pay full retail price for lift access so that it could offer skiers a pass to more than one resort, Aspen Skiing refused to accept even full retail price. The Supreme Court cited both the pre-existing business relationship between the competitors and the lack of a reasonable economic justification for declining full retail price for ski access in finding that the jury that decided the case could reasonably have inferred that Aspen Skiing's exclusionary conduct was anticompetitive. Here, CBOT has had no pre-existing business relationship with ELX. Moreover, the Advisory Notice did not reflect a change in policy at CBOT – it was issued in response to ELX's public statements purporting to interpret CBOT Rule 538. Had ELX not issued public statements purporting to interpret CBOT's rule, CBOT would not have had any reason to clarify the scope of CBOT Rule 538 for its members, since CBOT never permitted the transactions contemplated by ELX's EFF Rule.

Furthermore, unlike Aspen Skiing, CBOT has reasonable economic (and business) justifications for issuing its Advisory Notice. As discussed in response to the Commission's first question, CBOT has concluded that the transactions contemplated by the ELX EFF Rule, if effectuated, would adversely impact transparency and liquidity in CBOT's Treasury futures market. As the Commission is aware, the success of a contract market in the futures industry depends on the liquidity and transparency of its markets. Thus, the issuance of the Advisory Notice certainly was justified in response to ELX's public statements regarding the meaning of CBOT Rule 538.

Contrary to ELX's suggestion, an exchange's refusal to adopt new rules or amend established rules in order to assist a competitor is not the kind of behavior contemplated by Core Principle 18; it also is contrary to the specific findings of the Supreme Court in *Trinko* as strongly re-affirmed in *Linkline* and its progeny. Thus, CBOT is not unreasonably restraining trade in violation of Core Principle 18 by refusing to structure its rules in the way that will best facilitate the transfer of its open book of business to OCC in order to assist ELX in its efforts to acquire a greater market share of Treasury futures contracts. Because the Advisory Notice complies with Core Principle 18 − the only provision of the CEA CBOT is alleged to have violated − the Commission may not take action against CBOT pursuant to either Sections 8a(7) or 6b of the CEA as ELX argues. (Jan. 4 Letter at 9.)

VI. CBOT's Self-Certification of the Advisory Notice Is Not a "False Certification" Within the Meaning of Regulation 40.6(b)

Regulation 40.6(b), in relevant part, provides that the Commission may stay "the effectiveness of a rule implemented pursuant to paragraph (a) of this section during the pendency of Commission proceedings for filing a false certification or to alter or amend the rule pursuant to section 8a(7) of the Act." (Reg. 40.6(b).) Although Regulation 40.6 does not define the term "false certification," in its November 16 Submission, CBOT attested that there was nothing "false" or otherwise incorrect in its Advisory Notice. CBOT maintains this position today.

As previously noted, ELX's Request for Stay is itself based on false information. ELX states that "CME contends that it does not accept 'contingent or transitory EFRPs,'" (Request for Stay at 2) yet the Advisory Notice clearly was issued on behalf of the DCM CBOT, and explicitly states that "*CBOT* rules do not and have never permitted a futures contract to be used as the related position component of an EFR transaction" and that "a prearranged, matched pair of block trades that are executed for the purpose of moving a futures position from one clearing house to another are *both contingent and transitory trades*, and under *CBOT* rules, may not be employed to create or liquidate a futures position." (Advisory Notice at 1 (emphases added).)

As explained in CBOT's November 16 Submission, although at one time CBOT did allow transitory EFRP trades in its metals complex, CBOT's current rules prohibit both contingent and transitory trades. Contrary to ELX's contention that CBOT permits transitory EFRPs in its agricultural products (Request for Stay at 2) the referenced transactions are not transitory in nature. Indeed, in the transactions referenced in ELX's Request for Stay, there is no obligation by either party to do the second EFRP; instead, a non-transferable right to effectuate the second EFRP at some future date is granted by one party to the other. ELX does not, because it cannot, explain how a non-transferable right to effectuate the second EFRP at some future date renders the transaction transitory.

Without mischaracterizing the content of the Advisory Notice, ELX cannot claim that any aspect of the Advisory Notice contains false information. Indeed, nowhere in its Request for Stay does ELX attempt to challenge the veracity of the *actual* statements made in the Advisory Notice by CBOT. Moreover, CBOT – the DCM at issue here – has authority to interpret its rules and make a determination as to the types of trades permitted on its exchange so long as its rules are consistent with the CEA. Just as ELX's Rule IV did not expressly permit EFFs prior to its recent amendment, CBOT's rules do not – and have never – expressly permitted EFFs. As previously noted, the Advisory Notice was issued only to correct the inaccurate information disseminated by ELX respecting CBOT Rule 538's application to EFFs. Indeed, it is entirely inappropriate for ELX to be issuing public regulatory guidance with respect to CBOT rules, and had it not done so, CBOT would not have issued the Advisory Notice, since Rule 538 never permitted the trades contemplated by ELX's EFF Rule. That ELX disagrees with CBOT's reading of *its own rules* does not render that interpretation "false."

ELX appears to have retreated from its contention that the Advisory Notice is a "false certification" as it makes no mention of such issue in its January 4 Letter. Rather, the letter states that the Advisory Notice is "disingenuous" and that it is "technically accurate." While the letter characterizes the Advisory Notice as "seriously misleading," it does so on the basis of ELX's claim that CBOT's rules "do not prohibit

the EFF transaction contemplated by ELX's EFF Rule." The Advisory Notice cannot be "seriously misleading" on this basis when ELX's *own* Rule Filing, by expressly requesting that the Commission require CBOT to amend the rule so that ELX's EFF could be "implemented," concedes that EFFs were not permitted by CBOT Rule 538.[21]

In support of its contention that the Advisory Notice constitutes a "false certification" within the meaning of Regulation 40.6(b), ELX also argues that an EFF is "factually not a transitory trade." (Request for Stay at 3.) Specifically, ELX argues that "A transitory trade involves the rapid or prearranged purchase and sale of *the same* contracts between the parties. Here the parties are exchanging different contracts … and thus the EFF trade as proposed by ELX and approved by the Commission is not transitory or contingent." (Request for Stay at 3 (emphasis in original).) This statement flatly contradicts the representations ELX made in its Rule Filing. Indeed, in its Rule Filing, ELX states that these same contracts are "identical." (Rule Filing at 1.) Moreover, as discussed in Section II *supra*, the contracts are in fact the *same* contracts. Thus, ELX's characterization of the EFF transactions contemplated by its EFF Rule as not transitory is simply inaccurate.

Moreover, that the Staff appears to disagree with CBOT's application of wash and fictitious trading precedent to the transactions contemplated by ELX's EFF Rule does not render the Advisory Notice a "false certification" within the meaning of Regulation 40.6(b). CBOT is aware of no Commission precedent that exempts the EFF transactions contemplated by ELX's rule from prosecution under the Commission's wash or fictitious trading precedent. Moreover, while the Staff seems to have assumed that CBOT's Treasury futures contracts and ELX's Treasury futures contracts are different and therefore involve market risk, the Staff Letter does not include a statement to this effect nor does it provide any rationale that would support such a conclusion. Because these CBOT and ELX contracts are the same and no market risk is involved in the contemplated EFF transaction, the statements made in the Advisory are not "false."

Finally, as previously noted, CBOT has on several prior occasions issued advisory notices stating, in substance, the content of the Advisory Notice at issue here. The Commission has never taken action with respect to those advisory notices, nor at any time prior to the issuance of the Advisory Notice at issue here did the Commission notify CBOT that the rationale set forth in those notices was no longer valid under Commission precedent. Thus, CBOT had no reason to believe there was anything "false" or inaccurate in the Advisory Notice.

For all these reasons, the Advisory Notice does not constitute a "false certification" within the meaning of Regulation 40.6(b).

VII. Response to the Assertion in the ELX Letter That CME Group Designated Contract Markets Have "in a number of markets, and for many years, accepted transitory trades."

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[21] As discussed in detail in the November 16 Submission, transactions effectuated on two separate contract markets can qualify as wash trades under Commission precedent. *See, e.g., In the Matter of Joseph B. Knauth, Jr.,* CFTC Docket No. 04-15; *In the Matter of Byron G. Biggs,* CFTC Docket No. 04-22.

As the Commission is aware, CME Group Inc. ("CME Group") was formed in 2007 following the merger of CME Holdings and CBOT Holdings. At the creation of CME Group, CBOT and the CME became wholly owned subsidiaries of CME Group. When CME acquired NYMEX in 2008, NYMEX also became a wholly owned subsidiary of CME Group.[22] CME Group is not a designated contract market pursuant to the CEA, nor has it been delegated any SRO responsibilities with respect to its subsidiary contract markets. Designated contract market status is maintained individually by each of CME, CBOT, NYMEX and COMEX. Thus, each designated contract market is responsible for its *own* rules and operation and those rules are determined based on the characteristics of any particular market.[23] CBOT, for example, limits block trading and pre-execution communications in the electronic trading environment to a greater degree than CME, NYMEX or COMEX. None of these markets is answerable for or in any way responsible for the actions taken by another market. Thus, for purposes of the instant inquiry, CBOT respectfully submits that the only relevant contract market is CBOT.

Notwithstanding the foregoing, NYMEX, COMEX and CME permit transitory trades in limited circumstances that are permitted under the respective contract market's rules. Specifically, transitory EFRPs are permitted *only* in NYMEX energy and metals products, COMEX metals products, and CME foreign exchange products. Moreover, as noted in our response to the Commission's first question, the Commission recently has become more critical of transitory EFRPs. In its release in the fall of 2008 on proposed guidance for Core Principle 9, the Commission proposed two substantive amendments to its acceptable practices regarding EFRPs, including one that clarifies that transitory EFRPs are permissible *only* when each part of the transaction – the EFRP itself and the related cash transaction – is a stand-alone, bona fide transaction. Moreover, the Commission continues to prosecute as violations of the CEA transactions that are pre-arranged and intended to negate market risk.

VIII. Response to the question "why, despite the statement in CME Group Advisory Notice RA0901-5 that the four CME Group exchanges are adopting harmonized rule language with respect to Rule 538, the CBOT Advisory Notice Prohibits EFFs while EFFs are permitted on COMEX."

As explained in our November 16 Submission, neither COMEX nor any of the other three CME Group exchanges permits EFFs. We assume for purposes of this response that, in framing this question, the Commission had in mind the London Metals Exchange ("LME") copper contract that COMEX permitted to be used as part of an EFP. The LME contracts are appropriately considered forward rather than futures contracts and therefore have been permitted as the physical leg of an EFP; COMEX did not, and does not, consider such a transaction to be an EFF.[24]

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[22] Prior to the CME Group's acquisition of NYMEX, COMEX was a subsidiary of NYMEX. COMEX remains a subsidiary of NYMEX today.

[23] Each of the DCMs owned by CME Group has its own rules respecting the rule approval process. Indeed, the CBOT rule approval process is different in key respects from the rules of CME Group's other DCMs. (*Compare* CBOT Rule 230J *with* CME Rule 230J and NYMEX Rule 230J.)

[24] *See, for example:*
The Professional Risk Managers' Guide to Financial Markets, Alexander and Sheedy, 2007, p.169: "Most forwards are not traded on exchanges, but there are anomalies. For example, on the LME, forwards are traded."

IX. Conclusion

For the foregoing reasons, CBOT's Rule 538 and its Advisory Notice are entirely accurate. Indeed, neither constitutes a "false certification" under the meaning of Regulation 40.6(b). Moreover, for the reasons set forth above, CBOT Rule 538 and the Advisory Notice comply with Core Principle 18. Accordingly, ELX's Request for Stay should be denied and this inquiry should be ended.

If you have any comments or questions, please feel free to contact me at (312) 930-3488 or Kathleen.Cronin@cmegroup.com, or Brian Regan, Managing Director, Regulatory Counsel at (212) 299-2207 or Brian.Regan@cmegroup.com.

Sincerely,

Kathleen Cronin
Managing Director, General Counsel and Corporate Secretary
The Board of Trade of the City of Chicago, Inc.

Futures and Options, Spence, 1997, p.20: "The LME is not a futures market in the traditional sense – it is more a forward market."